A SUCCESSFUL INVESTOR'S LETTERS TO HIS SON

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First Printing, December 1934
Second Printing, January 1935
Third Printing, February 1935
Fourth Printing, February 1935

PRINTED IN THE U S A

A Successful Investor's Letters to His Son

By

KARL HELLBERG

CARTER PRESS
MINNEAPOLIS

CARTER PRESS
MINNEAPOLIS, MINNESOTA

TO

INVESTORS WHO WILL THINK

The Author

This book is inscribed to "investors who will think." It has been written to provoke thought. It does provoke thought. It will have more influence on the rapidly changing investment thought and practice of the country than anything else that so far has been written on the subject of investment. The author obviously knows his subject. His proofs are incontrovertible. He believes, and we agree with him, that the words of those who are "qualified" to write on the subject of investment have long since lost their force. We prefer, therefore, to abide by his *nom de plume;* to let the book stand or fall on its merit, regardless of authorship. Please do not write to us asking "who" the author is and whether he is "qualified." He may be a New York investment banker, or he may be an investor from Topeka, Kansas. Whichever or whatever he is, we believe is of no moment. Those who do not want to think for themselves are advised not to read "A Successful Investor's Letters to His Son."

The Publishers.

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Letter No. 1

WHAT CONSTITUTES INVESTMENT MANAGEMENT?

Chicago, March 15, 1933

Dear Robert:

I am glad you have written me about your investment difficulties. You are but retreading the path I have covered during the thirty years through which I have been an investor. I have an idea, too, that the period now confronting us—with its governmental regulation of business and its stupendous Federal outlay in relief and public works, together with its monetary manipulation—is going to require pretty careful investment management if you are to come through with a whole hide.

So much you and I read on investments, it seems to me, tends to perpetuate our ignorance of finance, our unfounded hopes or unwarranted fears, our foolish prejudices and misconceptions. Most newspaper articles and almost all of the financial advertising we get, appear to me to be aiming at supplying the demand of untutored investors for something they do not need and should not have, instead of teaching them what they should be looking for. In this and subsequent letters I am going to try to unmask those hopes, fears, prejudices and misconceptions; and leave you a clear perspective of the real problems which confront you as an investor—as a manager of money.

Managing money, whether you have $1000 or $1,000,000, is a complex problem involving a host of contributing lesser problems. Unless you know what you are doing, you soon find yourself wandering in a maze of rates, yields, earnings,

recommendations, tips and propaganda, with only a remote conception of the forces which are really important factors affecting your financial well-being. Oftentimes the right road and the wrong one look so much alike. And again, the wrong road, where it branches off from the right, may have been newly graded and beautifully landscaped.

Every investor knows what he wants to accomplish, i. e., conserve the principal he has already accumulated and then secure as much income, and as much capital gain as is consistent with reasonable safety. Few, however, can answer with any degree of accuracy, a question which they must answer if they are to attain any measure of investment success. Do you know the question?—"What constitutes investment management?" You, yourself, tell me that you "check earnings, investigate managements, study capital structures and generally strive to procure safety, a fair yield, marketability, and a reasonable opportunity for profit." That answer, in itself, Robert, proves you to be a thoroughly amateur investor and leads me to believe that you have "little conception of the forces which are the really important factors affecting your financial well-being." Your "strive to procure safety, a fair yield, etc." is a school book generality which is simply another way of saying that you "strive to manage money." The question is: "What constitutes investment management?" How do you do it? What methods do you use? And why?

Before you can think of even attempting to manage money, you must have a clear conception of the three major problems involved. Let me see if I can set them down clearly:

Successful investment management involves three important steps:

1st, Major trends of business and of security prices must

be anticipated with a fair degree of accuracy; and those types of investments used which will best conserve capital in falling markets and assure profits in rising markets.

2nd, Whether the trend of average security prices be up or down, the investment manager must determine, with a fair degree of accuracy, the future prospects of each of thirty odd major industries (such as the steel industry, the petroleum industry or the automobile industry).

3rd, Having determined what type of security is best suited to the current trend of business and prices; and having determined what industries are in a favorable position, the investment manager will then (and not until then) proceed to select the best individual corporations among the most favored industries.

Assuming that the above is a correct definition of successful investment procedure (which I shall prove to your complete satisfaction), you can see at once that you have been attempting to manage your capital by employing only step number three. This unfortunately is true of a great majority of investors Not even suspecting the existence of the two most important steps, it is little wonder that their investment results are far from satisfactory.

Your investment education is going to require a series of letters which I shall write as I have time, confining myself as nearly as possible to one important subject in each letter. My next will be on the subject of business and security price trends and the selection of that *type* of security which best conforms to a given trend.

Your affectionate father,

John Gordon

LESSON NO. 1

You must know what constitutes investment management.

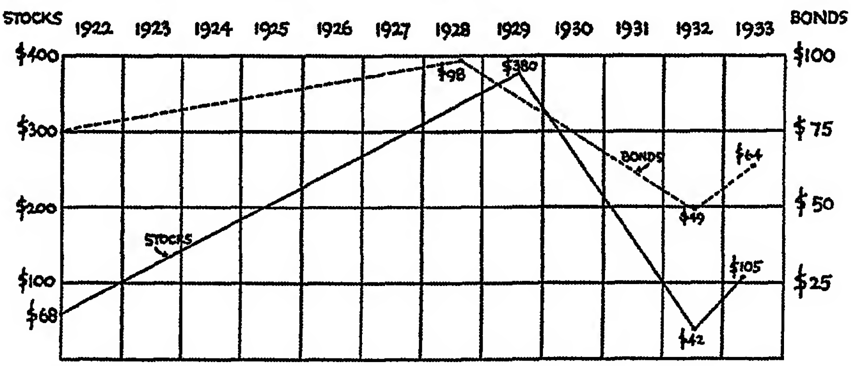
Letter No. 2

FITTING INVESTMENT TYPES TO BUSINESS TRENDS

Chicago, April 4, 1933

Dear Robert:

We have but to look backward for the last 3½ years to find an example, and a lurid one, of a trend in business and in security prices. On October 1st, 1929, the price per share of the theoretical "average industrial stock," as reported by Dow-Jones & Co., was $380. On July 1st, 1932, it was $42. Today it is $105. The price of the average long term bond in 1929 was $98. In July, 1932, it was $49, and today it stands at $64. Going back to 1921, we find the average stock at $68, and the average bond at $75.



Within the short space of a dozen years, then, we see a fluctuation of stock prices from $68, up to $380; down to $42, and back to $105. We see bond prices from $75, up to $98, down to $49, and back to $64. These fluctuations are representative of the "long trends" mentioned in my last letter, in answer to the question, "What constitutes investment management?"

To ignore these mighty trends is to ignore by far the most important factor in your investment management. It takes

little acumen to see that the owner of common stocks from 1921 to 1929 made rich profits; while from 1929 to 1932, he suffered damaging losses. So, too, the holder of bonds from 1921 to 1928 secured a good appreciation, while from 1928 to 1932, he suffered severe losses.

It seems never to have occurred to you that your results could be immeasurably improved by holding the proper *types* of securities during the major portion of a long up trend; then sell them and avoid the disastrous losses which are certain to result from the major down trends. There are a number of reasons why you have not even attempted this logical procedure. I do not want to digress from the subject of this letter to the extent of enumerating them now, but will call these reasons to your attention from time to time as we proceed. But to get back to those long trends. What causes them? Is it the tariff? Is it the supply of gold? Is it the crops? Is it foreign trade? Exports? Imports? Is it the shortage of money? Or its plethora? Is it politics? Is it the rise or fall of commodity prices? Is it public over-optimism or pessimism? Is it congress or the President? Is it England? Is it the effect of war? Or anticipation of war? Is it the unreasonableness of labor? Or the greed of "the international bankers?"

Yes, it is It is every one of them and many more besides. This highly developed economy of ours rests upon the constant interplay of a hundred financial forces. Each one must be constantly considered and its effect weighed against other forces which normally offset it. As long as the balance is maintained, "normalcy" endures; but when the delicate interrelation of these forces and groups of forces gets out of balance with other forces and groups of forces, then the keen, expert observer is able to anticipate the change in

trend which is sure to follow. These forces, if understood, have their exponents which chart, usually far in advance, the coming changes.

I promised you, a page or two back, to point out some of the reasons why inexpert investors are unable to anticipate these long trend changes. One reason is that the average man does not have the proper temperament for this sort of maneuver. This is particularly true of your and my types, the business or professional man, who is thoroughly engrossed in his own vocation or profession and is seldom able to assume the detachment from current happenings, which is so essential to long trend prognostication.

Investment management, or at least that phase of investment management which we are now contemplating, must not confuse the long trend, which it *is* possible to foresee, with the short swings in security prices which it is utterly impossible to predict. Security prices, and particularly common stock prices, are subject to three kinds of market movements. First we have the long trends which we are now discussing. These usually last from two to five or six years, and occasionally, a little longer. Next, we have the "short swings," secondary reactions—swinging up in a long, down trend market; and down, in a long up trend market. These secondary reactions usually occupy as many months as the long trends do years. And lastly there are the day-to-day and week-to-week, tertiary movements, within the secondary movements. These three movements have been likened to the tide, the waves and the ripples.

Majestically, deliberately (and predictably) the tide ebbs and flows. Upon the tide, whether in or out, fret the waves. Sometimes this way, sometimes that, unpredictable as the wind which drives them. And then, on the waves, the rip-

ples. Elusive as the proverbial flea. This way, that way, anybody's guess. The expert investor never becomes an expert until he is able to free himself from the rainbow chasing delusion of trying to predict the course of the fickle wind and the meaningless jumps of the erratic flea. Not understanding the long trend "tide movements," nor the forces which control them, you are likely to mistake the short swing for the long trend and vice versa. You are nervous. Jumpy. You are used to action. You think something ought to be done. You do not realize that successful investment managers have long since learned that far better results are achieved by ignoring the short swings entirely. Your anxious, get-things-done temperament becomes so confused in your worry about the short swings, that you lose your perspective on the long trends. It is the best illustration I know, of not being able to see the woods for the trees.

A current financial magazine says that the prediction is often heard that Wall Street may have to adopt the more conservative English trading system: that English traders, while not so quick on the trigger, are more level headed and seem to know more about American markets than Wall Street does. It says that the Englishman is not a seeker of quick profits and usually invests for the long trend. The most revealing statement, however, is to the effect that the citizens of both nations have, at one time or another, suffered from the speculation (short swing) mania; but that England has learned her lesson while we have not.

But, to get back to our subject, we have seen that these trends in business activity and in security prices do occur and reoccur, just as surely as the tide ebbs and flows, though with less regularity.

Our problem then is one of suiting to these trends, those

types of securities which will conserve capital in times of depression and increase capital in times of plenty. Securities generally may be divided into three classes or *types,* as follows: (1) equities or common stocks, (2) long term bonds and preferred stocks, and (3) short term bonds and other cash equivalents. Properly selected common stocks will be safe and profitable in periods of increasing business activity and unsafe and unprofitable in periods of depression. Properly selected long term bonds and preferred stocks will rise in periods of falling interest rates; and fall, as interest rates rise. Short term bonds and other "cash equivalents" are essential to capital conservation in depression periods. The investment manager cannot ignore these business and security price trends. You must anticipate them with a fair degree of accuracy. And you must allocate to the respective trends the *type* of investment whose characteristics are best suited to cope with those conditions.

Logical and elementary as this procedure is, it is astonishing how relatively few investors follow it. One reason is that they are sometimes led by those who have no interest in trends. Consider the "customer ownership" campaigns of the utility companies for instance. They are interested in deriving a steady cash income year in and year out from the sale of their stock. Whether falling interest rates or other conditions drive the price of the stock down is immaterial to them. Their motive is entirely company inspired. This example is but one of many I shall point out to you as we proceed. You will hear the representatives of another school of thought say that it is impossible to anticipate trends and that the best thing for you to do is to carry the same investments all the time, regardless of trends: that sooner or later falling prices will rise, etc. This is known as the "long

pull" method. These people lose sight of two things. One is that you, sooner or later, will want your money again for one purpose or another; and when you want it most, is usually when the investment market is at a low ebb. The other thing they forget or ignore is that anticipating the long trends "with a fair degree of accuracy" can be done It has been done. It is being done. I, for instance, used common stocks in my account very largely for some years up to the spring of 1929. Then, "anticipating a change of trend with a fair degree of accuracy," I changed to short term bonds for a period of three and one-half years Now I am back in stocks again I missed the top of the 1929 market by five months and I missed the bottom in 1932 by as many more; but I feel that the changes were made "with a fair degree of accuracy," which is all that should be expected. Two classes of investors will never be able to make such changes. One does not understand about trends and is probably advised by those who have no occasion to consider trends. The other, having seen the light, attempts to prophesy the courses of the waves and the ripples and in so doing ruins his judgment for the long trends.

And then you find another variety of person who is always attempting to direct this quadrennium's investments with methods that would have been proper for last quadrennium's problems. There are thousands of investors today, for example, who now realize that during the last four years they should have had their funds in short term bonds or other cash equivalents. Having "learned their lesson," they are now buying short term governments and life insurance annuities right in the face of inflation! What these misguided investors cannot see is that a type of security which is safe at one time and under one set of conditions, may be extremely hazardous at

another time, under a different set of conditions. A material degree of inflation, for instance, can make even cash in your bank, or U. S. government bonds, far more speculative than common stocks or even commodities. I am going to devote a letter to inflation a little later. Suffice it to say now that practically without exception, those able, expert and unbiased investment managers who were in short term bonds during the depression, are now back in common stocks or other inflation "hedges." Inflation raises commodity prices. Rising commodity prices increase the profits of properly selected corporations. This means rising prices for the common stocks of such companies. Furthermore, there is the added problem of protecting the "purchasing power" of your dollar. But I am getting ahead of my story and this too must wait for the letter on inflation.

There is just one more subject I want to touch upon in this letter and that is the much publicized propaganda that "everybody lost most of his money during the depression." I say "propaganda" because I cannot help feeling that a large part of it *is* propaganda, inspired by those, first, who made money and do not want it known; and second by those whose advice to investors was unsound and who therefore seek vindication in the "everybody lost" excuse. Everybody did not lose money during the depression. I did not for one, and thousands of other clear sighted or well advised investors did not. On the other hand, I suspect that a great many market operators who sold the market short in 1929, reaped unbelievably tremendous fortunes. It was not that everybody lost. The great majority lost. The few gained. And the great majority will lose again and keep on losing. The relatively few, who will apply just about half as much study

as is required to learn to play a fair game of bridge, will learn how to protect themselves.

Your affectionate father,

JOHN GORDON

LESSON NO. 2

You must anticipate, with a fair degree of accuracy, the long investment trends and shift to that type of security which will best protect your interests.

Letter No. 3

INDUSTRIES—"UP 2200%" Vs. "DOWN 73%"

Chicago, May 16, 1933

Dear Robert:

Determining the trend and suiting type of security to that trend, while of greatest importance, is by no means the be-all and end-all of investment management. The second and almost equally important step is the study of the various *industries*—some thirty as generally classified. One might think, without study or research on the subject, that the securities of all industries advanced during 1921-1929, the greatest bull market in history. But such is not the case. I have before me a study* showing how the common stocks of twenty-six major industries fared from 1918 to 1928, which for all practical purposes will serve to illustrate my point. The average stock during that period rose 220%, but not so the stocks in every industry. Chemical company stocks rose 150%; public utility companies, 194%; farm machinery, 203%; tobacco stocks, 208%; railroad equipments, 214%; mail order houses, 245%; electric equipment companies, 321%; stocks of food companies, 563%; and finally, automobile accessory companies, over 2200%.

But while those industries were showing such marvelous gains, others were not doing nearly so well. Stocks of the steel industry gained only 73%; the copper industry, 51%; theatres, 44%; oil companies, 42%; and the rubber industry, only 18%. But that is not the whole story. During that greatest market in all history, the leather companies actually

*"A Scientific Approach to Investment Management" by Dwight C Rose Harper and Brothers, New York—$2.50.

lost 1% in price quotations; the coal industry declined 10%; stocks of the textile industry, 12%; the sugar industry, 15%; and the shipping industry headed the list of losers with a loss of 73%!

This same variation in the performance of the different *industries* was also very noticeable in the period of the French post-war inflation period, from 1919 to 1927. Strange as it may seem, the French textile stocks—an industry which was having difficulties in America during practically the same period—rose 333% from 1919 to 1926. At the other extreme we find the naval construction industry whose stocks lost 72% of their value during the same period.* Thus we see that an error in selecting the proper industries, even in boom or inflation times, can be very serious.

A study of price trends of stocks in each industry brings out another point in support of the "long trend" method of operation. During 1919 the shipping industry stocks advanced much faster than the average. But by 1921 they had registered a 65% drop from the record of the average. Again in 1921-1922, this industry's stocks spurted up faster than the average was advancing, though not enough to catch it. Thereafter it fell off and fell off until, as stated above, it finally lost 73% during the ten year period. Now, assume, if you will, that you had foreseen long term trouble for the shipping industry in 1918. No sooner were you out of it, however, than it proceeded to shoot up ahead of other industries. You probably would have been rather provoked at yourself and perhaps have doubted your own or your investment adviser's judgment. These things can happen, do happen, and will continue to happen. Perhaps it has never occurred to you that the holders of large blocks of stocks in

* From "A Study of the French Post-War Inflation" by Morton and Drury.

a sick industry would like to unload. The "public" never gets greatly interested in any security or group of securities unless the market is active and rising. What more logical for the wise owners of these stocks than to create a "pool" to run them up and unload on the public? It has been done a thousand times and will be done a thousand times more, I fear, in spite of the new Securities Act. Another device of those "in the know" is in connection with an industry which is about ready to show a pronounced advance. In this case, the reverse operation is sometimes employed. The pool manipulates the price downward this time until it has squeezed out the poorly margined, and scared out those who are only guessing. Then the good news breaks and the stocks bound up to their new level reflecting the better situation of the industry. This is just another lesson for you regarding "long trend" holding versus the "short swing." "Short swings" can be manufactured. Long trends cannot. It would be fortunate indeed for investment managers to be good enough guessers to ride up with the pool and then get out just at the right time before the drop. Good investment managers, however, never guess. They take a position in an industry for a reason, and hold it for a reason; and are not worried about secondary reactions or week-to-week fluctuations. They may be out of an industry six months or a year too soon; or in it six months or a year too late; but when the score is marked up as the years go by, the good managers will still have their capital with a good profit added to it.

Your affectionate father,

JOHN GORDON

LESSON NO. 3

You must realize that *industries* have their ups and downs; and be able to anticipate the fortunes of the various *industries* with a fair degree of accuracy.

LETTER No. 4

HOW TO VALUE INDIVIDUAL CORPORATIONS

Chicago, June 9, 1933

DEAR ROBERT:

Your last letter says that I am not giving you much constructive help; that I am merely pointing out the difficulties of managing money. That is true. I intend these first four letters chiefly as a presentation of the investment problem. Let's find out what the problem is, first. Later on, we'll try to solve it.

We now understand the paramount importance of a decision, first, as to what *type* of security the major portion of our investment account should comprise. Second, we understand the vital necessity of selecting *industries* which are in a favorable position.

The third function of your investment management consists of passing intelligently upon individual corporations, within the favored industries. How important this is, may be seen from the record of the automobile industry in the year 1926.* Representative of the auto industry at that time, were the following ten companies: Chandler-Cleveland, Chrysler, General Motors, Hupp, Mack Truck, Packard, Pierce Arrow, Studebaker, White and Willys Overland. Ford is privately owned and figures for that year were not available. The stocks of the ten companies taken as a whole—the industry—made an advance. But it was all due to the record of General Motors. Every other company showed a decline. General Motors made enough advance to offset the decline of the others and show a profit for the entire indus-

*From Rose's "A Scientific Approach to Investment Management"

try. Many thousands of stockholders who were holding the right *type* of security and in one of the right *industries* still found their stocks going down because of their inability to select the right corporation.

You said in your first letter to me that you "check earnings, investigate management, study capital structure and generally strive to procure safety, a fair yield, marketability and a reasonable opportunity for profit." Let me tell you how a well equipped expert on motor stocks, whom I know, goes about it. In the first place, he evaluates the property of the corporation which he has under consideration, as follows: He ascertains the current earnings and estimates what proportion of those earnings can safely be paid out. Suppose, for instance, the company is earning $1,000,000 annually and in his opinion can well afford to pay out 60% of that, or $600,000 in dividends. He then decides (from his knowledge of hundreds of other stocks) what yield is reasonable to demand for the risk of investing in this corporation, instead of a riskless investment (riskless at that time) such as very short term U. S. government bonds. Perhaps he decides that 7% is a fair rate to receive for the risk involved. Assuming that it is 7%, he then concludes that 7% of the value of the corporation's business must be $600,000, for $600,000 is the amount they should and could safely pay out in dividends. To find the value of the entire property, he then divides $600,000 by .07 and learns that a fair value of the business is approximately $8,500,000. This figure he divides by the number of shares outstanding—say 500,000 shares—and finds that a fair value for the stock is $17 per share. Materially over that, the stock is selling too high. Under, it is a good buy. There is always a level where a stock is a "good buy"

or a "sale" on true values alone. People who *know values* recognize these levels. Others guess.

I am wondering if you have any such method of valuation. It is quite necessary, I assure you, unless you are to make costly errors. The average investor, I am sure you will agree with me, has little if any conception of the real worth of a stock. All too frequently his reason for buying is that it is going up rapidly; or that it has sold much higher. I may sometime forget, but I am sure Arthur Hallowell never will, his excitement when he dashed into my office to tell me that he had just bought a block of a certain shipping company stock. "Why?" I asked "Man alive," he fairly shouted, "that stock used to sell at $100 a share. Now it's $10. It can't help but go up." I passed up the easy money. Three months later the stock sold at $1.00.

Here again (in the selection of individual stocks) you must watch carefully that you don't get taken in by the rumors and tips which are constantly being circulated, usually with a purpose. The last one I fell for (we all do sometimes) was in 1928, as I recall. The Chicago manager of a well known brokerage house told me that they had inside information that the advertising campaign of a certain company was "going over big;" that the company was making scads of money and the stock was "going to $100 by Christmas." It was then selling around $38. I waited for a few days and was finally lured in by the age old ruse of a rising price. I bought at $44. It went on up to $47 under the stimulus of an able pool management and then, almost over night, dropped to $32 and kept on going down. The earnings report was issued shortly after that and it developed, as I might have known, that instead of "making scads of mon-

ey," they had been losing it. My broker friend, I am sure, was honest with me. He told me that when he recommended the stock to me, his New York office had told the Chicago office that "they were sitting right on the back porch" of the company. I guess they were. At least, they knew just the time to get out. That deal cost me $12,000; but, as a final lesson on tips, it probably saved me $100,000. They say the new Securities Act, or some other Act, will stop such practices, but I'll believe it when I hear of someone making money on a tip.

Your affectionate father,

John Gordon

LESSON NO. 4

You must be able to intelligently evaluate the stocks of corporations in which you propose to invest, and to compare the risk assumed with that of other corporations in the same industry.

Letter No. 5

"YOU'LL NEVER GET RICH DEFERRING LOSSES."

Chicago, August 4, 1933

Dear Robert:

I am not going to ignore the questions in your letter of July 25th, but please let me get to them in my own time.

How many times have you heard someone say: "I don't want to sell that stock. I'd have to take a loss in it." Or, "I don't care how low that bond goes, as long as it continues to pay."

It seems to me that such statements mark the inexperienced investor more quickly than anything else I can think of; and I've often wondered how such ideas have become so firmly implanted in the minds of so many people. A hundred recollections flock to my mind. James Boyle, whom you will remember as a long time friend of mine, once owned a block of a certain bond issue, for which he had paid par. I owned five of the bonds myself at the same figure. In the course of a few years after we bought them, the issue had slipped down to a price around 85. This would not have alarmed me at all if the whole bond market had been falling, but it hadn't. Bonds of the same rate and grade were holding right close to par. However, upon investigating farther, I found that the entire industry to which the company belonged was having difficulties; and that while the bonds of the strongest companies in the industry were holding up fairly in line with bond prices generally, several of the weaker companies' issues had fallen off, along with the one Mr. Boyle and I owned. This was enough for me. I sold my five bonds at 85 and pocketed my loss of $750. Chancing to

meet Mr. Boyle, I told him of my findings and of my sale and advised him to do the same. "No," he said, "I'll not 'take a loss' of any $750 on my bonds. Don't get alarmed They'll come back all right." But they didn't come back. At least they haven't yet, and that was five or six years ago. Two years later they had sunk to 30 and soon after, defaulted. Mr. Boyle now has to go through a receivership and I doubt very much whether he will eventually get more than $300 per $1,000 bond. He probably hasn't "taken" his $3,500 loss yet, but he has it nevertheless, just as he really had a $750 loss, as surely as I did, when I "took" mine, although he refused to "take" his. This fallacious "reluctance to take a loss" reasoning is hard for me to comprehend.

Several years ago it came to me that old John Anderson, who does odd jobs of carpentry for us, owned the stock of a small public utility company. It seems John's son had worked for this company at one time and had gotten him started buying their preferred stock. The company paid its dividends regularly and as John saved more money, he kept on buying more stock until he had seven thousand dollars in it—practically his life savings. I happened to know something about the affairs of that system, and a slight investigation of the local unit John was interested in convinced me that it was a poor place to have money. I called John in one day and told him of my investigation and advised him to sell out He thought well of the plan until I told him the price was only $80. John had paid $100 It didn't take him long to figure that his loss was $1400 "if he sold." He said he would "think it over" but when I saw him again several weeks later, he said he couldn't afford to "take" a $1400 loss and besides, the stock was paying its dividend regularly and he "didn't care how low it went as long as it kept on pay-

ing." Obviously John had been consulting the utility company office. Well, the stock kept on dropping and about the time it hit $40, it passed its dividend. It is now selling at $20. The company is one of those well watered promotions which will probably have difficulty in keeping its bond interest paid, much less paying anything on its preferred stock. John, who couldn't afford to lose $1400, now has a loss of $5,600. Furthermore, he recently had a stroke and is almost helpless. These people who figure on riding through periods when their securities "simply fall in price but keep on paying," seldom count on a possible imperative need for their money at the bottom or reckon with the possibility of omitted dividends.

What they cannot or will not understand is that declining quotations of an individual security—against the trend of a similar grade of securities—is a warning signal, a signal that should be investigated. And even supposing that the stock or bond in question does continue to pay and eventually regains its lost ground. Why take the risk of riding down with it? Suppose it drops to 50% of the price you pay and then, because of better conditions generally, or more favorable influences in that particular industry, it comes back. Is it not likely, especially in the case of common stocks, that the favorable conditions which bring the weak stock back, will give a corresponding impetus to another issue into which the investor might have transferred, at the time his original investment began to weaken?

If you want to change completely your attitude toward losses, inaugurate this plan in your method of operation: On a specified day each year, convert every investment you have into cash. Then study the situation carefully and immediately reinvest It will surprise you how much easier it

is to view your investments dispassionately when you have the cash instead of the securities. You will find that the perfectly natural, though thoroughly illogical temptation to hang on to an issue that is slipping badly, will be entirely removed. Such action, literally, will be well worth to you the brokerage commissions involved.

Perhaps this apparently inborn reluctance on the part of unskilled investors to part with a security, once they have bought it, is a reflection of their pride of possession. Perhaps having passed an approving judgment on it once, they are loath to admit the error which a change implies. Whatever the cause, it is a very unreasonable position to take and frequently a very costly one. I am no advocate of constant "switching," for no purpose; but when there is a valid reason for making a change, then former judgment, pride of possession or reluctance to take a loss should deter you not for one moment. Unskilled investors seem to be about equally divided between those who, as would-be traders, switch too often; and those who "can't afford to take the loss."

Some months ago an acquaintance of mine had decided to make an investment which necessitated disposing of a number of stocks he owned. I happened to be in his office as he was about to place his order with the broker to sell them. Some of his sales surprised me. I thought the issues he was disposing of were very good ones and if he had any adverse information, I wanted to know what it was. To my thorough astonishment, he replied that his sole reason for selling those particular stocks was that he had a profit over the price he had paid for them! I prevailed upon him to assume that he had sold all of his stocks, had the cash, and was reinvesting what was left, after making his other investment. He ran down the list, checking with his pencil those he would keep.

In five minutes he had changed his mind almost completely and disposed of many of the stocks in which he had a loss instead of a profit.

I've heard the saying, "You'll never go broke taking profits;" but I am quite convinced that "you'll never get rich deferring losses." I fear many an investor is quick to take profits and slow to take losses, whereas my rule is to be quick to take losses and slow to take profits. In a recent article by a noted English economist, I noted his reference to "the principle" of never taking over a 25% loss on any security. Not a bad idea Judgment must be used, of course, particularly when changing from one *type* of security to another, because it is difficult to estimate the exact bottom or the exact top of a great cyclical movement. With individual securities, however, when one you own begins to desert other securities of its type and grade—then it is time to investigate. Hundreds of fortunes, great and small, have been lost because of the dogged persistence of their managers in hanging on to forlorn hopes—because of the reluctance to "take a loss." "Hope," says a current financial magazine, "is that unbelievable force which holds the uninformed investor in a falling security with the flimsy promise to himself that he will get out 'as soon as he can break even'." "Hope," it says again, "is that incredible force which leads the novice to believe that there is a difference between a 'paper loss' and a 'real loss'."

Your affectionate father,

JOHN GORDON

LESSON NO. 5

If there is a valid reason for questioning the relative strength of a security you own, sell it—regardless of loss.

Letter No. 6

THE ERRONEOUS CONCEPTION OF INCOME

Chicago, September 9, 1933

Dear Robert:

There is probably no part of the investment problem which is so little comprehended—simple and commonplace as it sounds—as income or yield. The chief error is not, as you may suspect, in striving for too great a yield. The glaring misconception of the whole problem of investment management lies in the erroneous belief that money should earn a given rate each and every year, just as much in 1929, for instance, as in 1928. I have heard some men say that they always try to get seven per cent; others that they never buy anything that pays over four. One is just about as much in error as the other.

Undoubtedly it was this common error regarding "a steady income" that caused your greatest losses during 1929-1932. Those who sought income during a period of falling prices paid for what income they got, many times over, in loss of principal. What you should strive for is not 7%, or 4%, or even 2% each and every year; but an *average* of 4% or 7%, or more! And if you will aim at an average, and if you have a fair conception of what you are doing, you will find as the years go by that you still have your principal, plus a surprisingly large average income from it.

Let me give examples of the methods of three money managers. For the sake of convenience we shall call them, Mr. A, Mr. B and Mr. C, and shall assume that each had an equal amount of capital—$100,000 in May 1929. Mr. A invests only in bonds He is a fairly good buyer, but takes a loss occa-

sionally. He aims at 5%,—$5000 each and every year, and *had* usually made it. In May 1929 his $100,000 was invested in bonds and what is left of it still is. By May 1932 the current worth of his account was $40,000. Today with the comeback of the bond market, it is worth $60,000 after allowing for several casualties. His income hereafter will not exceed $3000, due to his losses during the depression.

Mr. B invests only in stocks. He still clings to the "long pull" theory, i. e., that a group of stocks should be held all the time, up hill and down, through good times and bad. He aims at 4% to 5% as a rate of return each and every year. By September 1929 his $100,000 had a current value of $120,000; but by June 1932 this had shrunk to about $20,000. Today, with the comeback in stock prices, it is worth $40,000. His income is now around $2,000.

Mr. C is what I call an investment manager. He buys both stocks and bonds in varying proportions. Depending upon conditions, he may have his account all in long term bonds, or all in common stocks. Or he may have half in each, or all in short term bonds or other cash equivalents. In May 1929 it was practically all in common stocks. At that time, however, he became greatly alarmed because of soaring interest rates and other adverse investment indexes, and converted his entire account into the very shortest term U. S. government bonds and other equally "cash equivalent" securities, the income from which was around 1%. Mr. C pays himself $6,000 a year from his account. He disregards the earnings of his capital and draws $500 per month whether it earns it or not. He operates on what might be called the "pay *yourself* dividends" plan. Obviously while his money was earning only 1% he had to deplete his capital at the rate of $5,000 per year. This is just what he did for 3½ years

He missed the rise which Mr. B enjoyed from May until September 1929 and the rise which occurred between July and December 1932. When he reinvested in common stocks in December 1932 he had $83,000. Today that $83,000 has increased to within a few hundred dollars of his original $100,000 and Mr. C is still drawing 6%. Note that Mr. C is no wizard. His too early fear took him out of stocks five months too soon in 1929 and his over caution put him back in them five months too late in 1932. He therefore missed ten months of rising prices. But he also missed thirty-two months of a generally falling market—and he has his principal and his income unimpaired. He anticipated the changes of trends "with a fair degree of accuracy." Mr. C, while no wizard, is neither a fool. He learned long ago the lesson I have tried to get across to you in Letter No. 2. You remember, about tides, waves and ripples. Had he attempted to dodge in and out of that 1929-1932 market he would have lost most of his money just as surely as they did who tried it.

You may ask, "Are these really actual experiences?" Of course they are. If you doubt it, talk to the next ten investors you meet and you will find Messrs. A and B represented by two-thirds of them at least. The country is full of A-s and B-s who "invested for income" during the depression. There are also thousands of Mr. X-s who are a composite of A and B—part in stocks and part in poorly selected, long term bonds. Mr. C is your father.

Now that we have seen the effects of investing for a steady income, let us seek the reasons which actuate this type of investor. Or perhaps I should say the inhibitions which deter him from becoming a "pay yourself dividends" investor. He is the man you hear say, "I must have income. I

wouldn't use any part of my principal as income, not for anything in the world." He does it very frequently, nonetheless. Let me cite a few instances:

(1) He owns a preferred stock which continues to pay dividends out of surplus, although not earning them. He is spending part of his capital though he does not realize it. Example: International Harvester.

(2) Or perhaps it is a common stock. Example: American Telephone and Telegraph Company. This company is paying dividends which it is not earning. He is using part of his capital there too.

(3) Or perhaps he cashed in the rights he used to get from Telephone. Those rights, as they were exercised, diluted his telephone stock—reduced his principal.

(4) Or perhaps he sold the stock dividends paid by North American Company and used the proceeds as income. The stock dividend again reduced the value of his capital. He was spending from principal.

(5) And maybe he cashed his distributions from a distributive type investment trust such as North American or Corporate Trust Shares. Again he was spending part of his principal.

Thus you see that the man who "wouldn't use any part of his principal" frequently does so, but doesn't realize that he is doing it.

Or if none of these examples convince you, can you deny that Mr. A and Mr. B were spending part of their principal in 1929-1932 when the very fact that they "wouldn't use part of their principal," as I did, and therefore sought income—caused them to deplete their principal far more than the income they received? The only difference between your dad's plan of "paying himself dividends" when his capital was not

earning them, and Mr. A's and Mr. B's plan of investing for income during the depression, is that my capital losses are limited to the amount of the "dividend" that I paid myself—out of one pocket into the other if you please. On the other hand, there is no limit to the capital losses of A and B, as any investor who sought income during 1929-1932 will testify.

Here is another thought on the subject:—Mr. B says that he cannot afford to invest in insurance company, chain store and other low income stocks because they don't pay enough; but he will invest in A. T. & T. because it is a high income payer. The chances are that Mr. B does not need the income at all and reinvests it as fast as he gets it. Let us compare the low dividend paying insurance stock with the high dividend paying Telephone, assuming that they both earn $9 a share, or 9% on a price of $100. Both companies are constantly in need of new money for expansion purposes, let us say 7% each year on the amount of stock outstanding. Telephone pays out practically all it earns and then raises its 7% expansion money by selling more stock. The insurance company pays out only 2% and uses the other 7% for its expansion program. The only difference to Mr. B is that with his telephone investment he must reinvest his entire 9%. Probably he buys more telephone stock. With the insurance stock, however, he need reinvest only 2%. The insurance company is reinvesting the other 7% for him. What is the difference? There is no difference.

"But," you say, "suppose Mr. B really does need his 9%?" And I say to you—and this is the point that many investors miss—if Mr. B needs the full 9%, let him sell off 7% of the amount of his insurance stock. It makes no difference in dollars and cents to him, I can assure you. The telephone

company dilutes its stock 7% each year (in the example I have used) by issuing new stock, thus decreasing the value of its stock that much. The insurance company adds 7% to the value of its stock each year. Everything else being equal, the insurance company stock that Mr. B has left will advance 7% more each year than Telephone; and it is this 7% which Mr. B sells. If you have any doubt about this, check back the price records of a number of the leading insurance stocks for fifteen or twenty years and compare them with Telephone's record.

The above discussion assumes "everything else being equal." But everything else is not always equal. Depressions will occur as we have lately seen. The man who "must have income" each and every year and who will not operate on the "pay yourself dividends" plan, will periodically lose sizable portions of his principal whether he invests in stocks or bonds.

My purpose in the last few paragraphs has been to impress upon you the extreme common sense of "paying yourself dividends." Don't make the rate any higher than necessary, but operate on that basis even if you have to pay yourself 10% per year. It will be much cheaper than "investing for income." This plan is new to the inexperienced investor but as old as the hills to that relatively few in number (but great in savings or profit) who avoided losses during the depression.

And now I hope you see why I said in the first part of this letter that the most glaring misconception of the whole problem of investment management lies in the erroneous belief that money should earn a given rate each and every year.

Your affectionate father,

JOHN GORDON

LESSON NO. 6

In your investment management, disregard entirely the factor of income Seek safety in bad times, profit in good times. "Pay yourself dividends," if necessary, but never seek income for income's sake. It is too costly

Letter No. 7

3 WAY DIVERSIFICATION

Chicago, October 2, 1933

Dear Robert:

This time I want to dwell to some extent on that homely old fundamental, diversification A volume easily could be written on the subject, particularly if experiences of misguided investors were to be chronicled. In discussing this subject, let us go back again to our question, "What Constitutes Investment Management?" You will recall that three main considerations are involved:

1. Types of securities
2. Industries
3. Individual corporations

Diversification, especially by the novice, should contemplate all three of these divisions.

Diversification As To Type

We have seen the disastrous results of neglecting type diversification, in the account of Mr. B in my last letter. The fairly able investment manager, like your dad, was sure enough of himself during the depression to confine his investments solely to the "cash equivalent" type. Even the inexperienced investor might well emulate him when the purpose of holding to a single type of security is safety of principal. Ordinarily, however, as a rule of thumb for the layman, a diversification of ⅓ of his account into each of the three major types would serve, at least as a starting point—⅓ in cash equivalents, ⅓ in long term bonds and preferred stocks, and ⅓ in common stocks. These percentages could

then be varied as conditions seem to warrant. Outstanding examples of failure to diversify as to type are those who invest only in stocks; or only in bonds. The stocks-only buyer gets badly hurt in a depression and the bonds-only buyer may be just as badly hurt in a period of inflation. (No, I have not forgotten that I promised you a letter on inflation.)

Diversification As To Industry

I presume that more investors unconsciously neglect this kind of diversification than either of the other two kinds. The ditches along the sides of Investment Boulevard are strewn with the financial wrecks who refused to, or neglected to, or did not realize that they should, diversify as to industry.

You probably remember Fred Heffron. He was worth $250,000 back in 1920. Fred had no use for stocks and bonds. He wanted his money in "something he could see." Farm land was his specialty. He was born on a farm. Grew up on a farm He knew farming. He literally loved the land. And he invested in land! He made farm mortgage loans. He owned land, fully paid for, and he owned equities in thousands of acres more. And Fred always had a round sum of cash in the bank too. Now, from the above you will note that Fred was adequately diversified as to type. His mortgages were the equivalent of bonds (except for marketability); his fully-paid-for farms were common stocks owned outright (except for marketability); his equities in the other lands were common stocks carried on margin (except for marketability); and his cash in bank was his "cash equivalent" position.

But all of his investments were in the same industry! When agriculture began to have its troubles, Fred began to

have his. Income stopped and he had to advance money for taxes and payments on the farms which were not fully paid for; and for taxes on those he owned outright. Next, the bank, also dependent upon agriculture, failed, depleting his cash fund. Next his farm debtors failed to pay their interest. He raised what he could on sacrifice sales of his mortgages in an endeavor to hang on. But it was no use. Fred went down, and out—surely a martyr to a poor cause: failure to diversify as to industry.

Another common example of inadequate diversification as to industry is the man who, "grown up in the railroad business," or any other business, makes all of his investments in that industry. Hundreds of railway executives today are actually dependent upon their salaries because they made all their investments in "the only industry they knew." These enthusiasts for their own industry "know" the railroad business all right, but the very fact that they are preeminent in railroading probably implies a neglect of other businesses and professions, among them the investment management profession. It is safe to say, at least, that anyone who has disregarded so fundamental an investment rule cannot qualify as an investment expert. And yet, the general impression is that men high in the walks of business are supreme in investment judgment.

The best illustrations of the need for diversification by industries that I have ever encountered, are the studies of the American 1921-1929 bull market and the French post-war inflation, mentioned in my letter No. 3. In each of these studies we saw that the prices of common stocks of several industries actually declined during those vigorous upward trends. Advances in the various industries in the American example, you will recall, varied from 18% for the rubber

industry to 2200% for the automobile accessory industry; while the French inflation produced advances ranging from 38% to 333%.

Let me interject a little warning here, Robert. The novice, who heretofore has probably never given a great deal of thought to the subject of diversification by industries, as soon as he realizes what vast differences in performance there are, immediately wonders if he cannot concentrate a goodly portion of his account in what is to be the leading industry in the next up trend If he consults an investment expert, he can't see why that expert cannot foretell the leading industry. "Why does he pose as an expert if he can't do that?" If I have not mentioned it before, the science of investing is not an exact science. Even the unbiased expert will do well to keep out of the losing industries and ahead of the average of those which advance. One of the things which makes the expert an expert, is averaging his risks among a number of industries, all of which seem to be in a favorable position. Something may happen to any of them.

Diversification As To Individual Corporations

When I come to this sub-head, it does seem that I ought not to have to say very much about it. But the fact remains that every year hundreds of thousands of investors, the country over, lose their big or little fortunes by disregarding individual corporation diversification. I know a lawyer, attorney for a large electric holding company, every dollar of whose fortune was concentrated in the company's stock. In 1929, this stock sold at $230 a share and he was a millionaire. Today, it sells at $2 a share and he is worth $10,000. John Anderson, the old carpenter, whom I mentioned in discussing industry diversification, committed a double error in not

only confining his life savings to one industry, but to a single corporation as well. Employees of railroads, electric light companies, banks and scores of other corporations make the same mistake of concentrating their savings in the stock of "their company." Their action is laudable from a loyalty point of view, but lamentable indeed from the angle of safety. Something *can* happen to *anything*.

Geographical diversification is sometimes advised. It is indeed advisable if you are investing in companies whose field of operation is restricted to a single locality. However, if the larger corporations, whose operations are nation-wide, if not world-wide, are used as investment media, it would not seem necessary to pay much attention to geographical diversification.

Your affectionate father,

JOHN GORDON

LESSON NO. 7

Diversify your investments (1) as to type, (2) as to industry, and (3) as to individual corporations

Letter No. 8

TRUE MARKETABILITY—AND WHY

Chicago, November 10, 1933

Dear Robert:

Ready marketability of your investments is essential if you are to manage your account with any degree of success. It is one thing to say that a given security is "readily salable" and another thing for it to be really marketable in the sense of the term I have in mind. However, it is not at all difficult to find out whether a security really has marketability in the true sense of the word. A house, or a farm or a business building is not readily marketable. You may have to search for months to find a buyer and in a period of falling prices, it is practically impossible to unload.

Farm and city mortgages have a greater degree of marketability than the actual property, but in periods unfavorable to the properties, the market quietly vanishes. During the last few years, for instance, it has been practically impossible to dispose of this class of security. The mortgage dealer will rightly say that the security is there and even if the debtor does not pay, you can take his farm or house. This only further reduces the marketability, however. Who wants all the bother, expense and notoriety of a foreclosure? Investments of this kind are all right for the insurance company, which has an organization to take care of them, but to the investor busy with his own affairs, they are a frightful nuisance.

A step up in marketability are the stock and bond originations of the investment banker. Most of these are not listed on any exchange. An "over-the-counter" market is main-

tained by the originating house. This over-the-counter market may provide an excellent degree of marketability when the investment business is brisk and securities are in demand. But when bad times come and it becomes increasingly difficult for the investment banker to resell his stocks or bonds, he has no choice but to "drop" the bid, i. e., pay a lower and lower price so that he won't have to buy back so many bonds or so much stock. But what you want is a market that does not fade away when conditions are changing and when it may be vitally important to switch from one type, or one industry, or one corporation, to another. Thousands of people who did foresee trouble in 1929, or who were so frightened by the first great slump in prices that they wanted to sell out their stocks and long term bonds and mortgages, could not do so because there was literally no market at all for the unlisted securities they held.

Listing on a security exchange very materially improves the situation, but does not necessarily correct it entirely. In the first place, it makes a great difference on what exchange the security is listed. Many exchanges are little more than advertised markets for securities sponsored by local dealers. The New York Stock Exchange and the New York Curb, in this country are far superior to any others. But even listing on either of these exchanges does not necessarily imply a high degree of marketability. There are issues of stocks and bonds on the New York Stock Exchange which haven't been traded for the last six months and probably won't be for the next. In addition to listing we must also look for issues which are actively traded. Activity is what makes marketability. Professional traders buy and sell largely in the most active issues, thus further promoting their activity. A long trend may move U. S. Steel from 250 down to 25;

but that move will be effected through thousands and thousands of trades so if you want to get out on the way down, you can get out. In less actively traded issues, there may be a close market today; while tomorrow or next week there may be a difference of $20 a share between sales. You understand, I am sure, that I do not contemplate active trading for you, but I do want you to invest in securities which are fairly active so that when it becomes necessary for you to switch from one *type* or *industry* or *corporation*, to another, you won't find yourself locked in.

One other point you must watch and that is the number of shares—not only the number of shares outstanding, but the number of shares in the hands of the general public Closely held issues or those with relatively little stock in the hands of the public can be manipulated much too easily for the comfort of the investor, who is always on the "outside," and usually on the wrong side when the "operators" are maneuvering it up and down.

Your affectionate father,

JOHN GORDON

LESSON NO 8

Always buy securities which are readily marketable, in the true sense of the term.

Letter No. 9

5 WAYS TO MEET INFLATION

Chicago, December 17, 1933

Dear Robert:

Your last letter leads me to believe that you are quite upset about inflation. I notice though that most of your attention seems to be focused on Washington. You are intolerant of the administration and its inflationary steps and argue as to whether it is economically sound or unsound, or morally right or wrong. Let's keep these letters on our subject, investing. As I see it, from the point of view of the investor, we are not concerned with the economic soundness or unsoundness of inflation, nor with the moral right or wrong of the move. What we are concerned with is: "How will it affect us as investors?"

Before I finish this letter, I shall tell you of five ways to meet inflation—five ways to protect your investment account against it; but the rather incoherent statements in your letter lead me to believe that you do not have a very clear conception of its causes or history. First, therefore, I am going to dwell at some length on cause and effect and on history. After that, we shall consider the investor-protection angle.

Why Inflation Is Confusing

Inflation is confusing to the average investor, first, because it is an attack from a quarter toward which he is accustomed to look for protection and safety—the federal government. It is confusing because the investor who suffers most from inflation is the one who does that which, under normal conditions, would be the most conservative thing to do. The

greatest sufferer is the man who holds cash, or obligations payable in cash, such as government, municipal and high grade corporation bonds, mortgages, etc. I fear you may not believe that statement (so unbelievable does it sound), or that you will think it a secretarial error, so I am going to say it over again in another way:—The investor must realize that everything he has been accustomed to do to "play safe" is exactly reversed in a period of inflation. There are numerous ways to protect yourself, but the one course which certainly will not work is the very one which a lifetime of investing has taught most people to regard as safe.

Another cause for confusion is the nomenclature of economics. Ask the next few men you meet to define inflation, deflation and purchasing power. You will receive a variety of replies, I assure you. Let's toy with those three terms for a few moments and see if we can't get a better idea of their meaning than most people have. Take inflation and deflation, for instance. One man talks about dollar or currency deflation and the next uses "inflation," apparently with exactly the same meaning. As a matter of fact, we do have dollar deflation and dollar inflation at precisely the same time; but the dollar deflation we mean, is deflation of the value of a dollar in terms of an ounce of gold. Thus an ounce of gold used to be worth $20.67. Now it is worth $35. A dollar used to be roughly 1/20 of an ounce of gold. Now it is 1/35 of an ounce of gold. Dollar or currency deflation means reduction in the value of the dollar in terms of gold. At the same time we have dollar or currency inflation also But here we mean inflation of the quantity of currency or dollars in circulation. As you see, there might be currency or dollar inflation without dollar deflation. But in America at this time we have both. Along with currency inflation,

sooner or later, we find price inflation—higher prices for things, i. e., commodities.

"Purchasing power," too, is a confusing term because there are two kinds of purchasing power. One refers to people, to their ability to buy—as "the purchasing power of the farmer" or of the wage earner. The other applies to the capital owned by the people, i. e., the "purchasing power of the dollar." Thus, if crops are poor or the prices of farm produce low, then the "purchasing power of the farmer" is low for the reason that, as a class, they have little money. But "purchasing power of the dollar" has an entirely different meaning. If prices of merchandise or commodities are low, then the purchasing power of the dollar is high, because a dollar will buy a lot of merchandise; but if the prices of merchandise are high, then the purchasing power of the dollar is reduced, because a dollar will buy much less merchandise. What we are concerned with, in discussing the affairs of the investor, is, of course, the "purchasing power of the dollar."

What Is Inflation?

Inflation is a financial maneuver, voluntary or involuntary, on the part of a government, the effect of which (and the intention, if it is voluntary, as ours is) is to raise the price of things—merchandise, commodities—iron, wheat, copper, furniture, wearing apparel, groceries, automobiles, bottles, real estate. And raising the price of merchandise or commodities, as we have seen, decreases the purchasing power of the dollar.

Poker Game "Inflation"

I remember once when you were in college, you told me about a poker game which illustrates "currency inflation" about as well as anything I can think of. As I recall it, it was

a five handed game and each player had bought $20 worth of chips. The "banker" lost heavily. In fact, he lost his $20 which was all the money he had, and then he borrowed from the "bank" until he had lost $100 more. By that time, he decided to stop playing and go home, although the rest of you wanted to continue. There were $200 worth of chips outstanding, but only $100 in the "bank" to pay off with. The boy who was the "banker" was in an embarrassing position. He couldn't pay and confessed it. Everybody "cashed in" on the basis of 50% of the value of his chips. The "banker" agreed to pay up as soon as he could pry an extra $100 out of his dad. I don't remember just what happened, but the game could have gone on with $1 chips worth 50c, 50c chips worth 25c, etc. In that case the value of the "currency" would have been deflated 50%, and the quantity, inflated 100%. As to purchasing power, twenty $1 blue chips, on the old basis would have been sufficient to buy a $10 pair of shoes and a $10 hat; but on the "revalued currency" basis, the same twenty $1 blue chips would buy only one shoe and half a hat. Purchasing power had been reduced 50% as the result of "inflation."

The effect is just the same when a government cannot or will not pay. The "chips" are less valuable. Purchasing power of the medium of exchange is reduced. "Chips" in the government game, which you and I use, are $1 bills and $20 bills and $1000 bonds and $10,000 notes. The "cash" in the government "bank" is gold. We "players in the government game" paid an ounce of gold, (or its equivalent) for about twenty blue chips, but now the twenty blue chips are worth only 4/7 of an ounce of gold. Stated the other way around, an ounce of gold is now worth $35, whereas it used to be worth $20.67. But so accustomed are most of us to con-

sider those $20 bills and those $1000 bonds as the unvarying standard, that we cannot realize what has happened. If everyone could be made to see it at one and the same time, the rise in prices of merchandise—commodities—would have occurred just as quickly as you boys in the poker game realized that your chips were worth only half as much as before. We investors, in this comparison, are nowhere nearly so keen. We can't seem to understand that the dollar is not the standard—the base; but only a "chip" in the government game which can be revalued by the "banker" at will.

The Same Street, But a New Measure Of Distance

Another analogy, which is perhaps even easier to vizualize, would be the re-laying-out of the street on which your mother and I live. As you know, it is five blocks from the Mordecai drug store corner. Suppose this street were to be re-layed-out into ten blocks. You arrive in town and tell your taxi "five blocks to the right from Mordecai's drug store." You will miss us by five blocks, and will have covered only half the distance you had planned on. The unit of measure has been reduced in value. And so it is with inflation. The old standard has been shortened. Objectives carefully planned on a basis of $10,000 of old money will be unattainable with $10,000 of the new money. Where $300 per month would be ample at current prices, it will take $400 or $500 or $600 or more (depending upon the degree of inflation) at inflation prices. In spite of the failure of millions of people to understand, the revaluation is gradually reflected in prices. Our $10 bill will not buy the same pair of shoes, nor the hat of the old quality. The car for which we pay $1000 gradually creeps up toward $2000. Groceries climb, rents rise. The

cost of living increases. Eventually we find ourselves on a higher plateau of prices. It is then that the investor who still has his cash equivalent, or fixed income securities, such as high grade bonds or mortgages, realizes what has been done to him. Those dollars, those "chips," which he has conserved so carefully, will buy only a fraction of what he thought they would buy, that fraction depending upon the degree of inflation. The "purchasing power of the dollar" has been reduced.

Inflation In England

Few investors have made a study of the history of economics. They do not know, for instance, that the volume of world business and credit is always increasing faster than the world supply of that base on which the superstructure of business and credit rests—Gold. They do not realize that history is but repeating itself; that inflation is no new thing; that it has occurred time and time again and usually following great wars.

England, for instance, has inflated five times within the last 700 years. Six hundred years, or thereabouts, ago, an ounce of gold in England was worth 22 shillings 9½ pence. In 1464 inflation raised the price of gold to 32 shillings 9½ pence. The inflation of 1549 raised the price to 60 shillings; 1665, to 80 shillings 11 pence; 1816, to 84 shillings 11½ pence and since 1931 it has stood rather unsteadily at 130 shillings per ounce.* The price of the money base—gold—has steadily risen in terms of the currencies of the world, from one price plateau to another, ever since money supplanted barter as a means of transacting business. The "purchasing power of money" is ever decreasing. Inflation is no new thing.

*From "The American Investor and the New Dollar," by Young and Ottley.

The Post-War Inflations In Germany And France

German and French investors, who did not understand, or take the trouble to find out, learned the inflation lesson to their sorrow from 1918 on. In Germany entire fortunes, if kept in bonds and mortgages, were wiped out completely. In France, it was not so bad—but bad enough. The holders of fixed income securities lost only about 65%, in terms of what they could buy with their money after their inflation. They had just as many francs but they could buy only 35% as much with them as they had planned. The "purchasing power" of the franc had decreased 65%.

The Frenchman who had planned to retire on 10,000 francs per year can pay only ⅓ of his living expenses. If he had saved to build a house for 50,000 francs, he finds now that the same house will cost 150,000 francs. In Germany, the unit of measure, the mark, became so small that it took millions of marks to buy things which before inflation cost only a few hundred.

Of course no one in America expects our inflation "to go to that extent." No one in Germany did either; nor in France; nor in England—that is, no one but those who understood. They conserved their capital. The others lost—all or a large percentage, depending upon the degree of inflation.

How Far Will It Go? How Long Will It Take?

I wish I could tell you. No one can tell in advance just how far it will go. That depends upon numerous factors—how much more, if any, the dollar is cut; how much more money is pumped into the country via relief, public works and the many other AAA's, HOLC's, XYZ's, etc.; the price of commodities at the beginning of inflation; supply and de-

mand of each individual commodity as the months and years go by; the trend of world prices; tariffs, etc., etc.

The insidiousness of this disease lies in its stealth. It creeps upon us The effects at first are slight. Many investors become alarmed and then are lulled to a false sense of security when nothing happens in a hurry. There usually are temporary delays and reactions which deceive others into believing that it has "blown over." It is a long, slow process—a typical "long trend" movement, as described in Letter No. 2. Short swing secondary reactions will happen again and again. Week-to-week and month-to-month fluctuations will be with us as well, but the "long trend" is the important thing to guard against. In France, it took seven years for the full measure of inflation to develop; and even in Germany, where the wreck was complete, it took five years.

The danger is here. What can we do about it? How can we protect ourselves against inflation?

Five Ways To Meet Inflation

What we must do is to put our money, or at least a part of it, into some sort of investment which will rise in dollar value along with the prices of the things we will want to spend our money for, when we have arrived atop the next price plateau. Gold, of course, would have been the perfect hedge; but the owning of gold by anyone except the government is outlawed, so this is impossible. There is a way to own gold indirectly, however, in spite of the edict of the United States government against its actual possession. You can buy it in the ground, plus the cost of getting it out, through the medium of the stocks of gold mining companies. Those of long dividend records and proven ore reserves should be selected if you want to keep in the investment

class. Care too should be exercised in choosing those which are not over-valued in price, and that depends upon a number of factors perceptible only to the investment expert.

There would seem to be five different kinds of investments by which inflation can be combatted:

1. Real estate
2. Foreign bonds
3. Foreign common stocks
4. American common stocks
5. Commodities

Let us consider each of these for a few moments.

Real Estate is a good form of extra long term investment, but in considering it as a hedge against inflation, bear in mind the following:

(a) Real estate is usually the last commodity to derive price stimulation from inflation.

(b) It lacks ready marketability which is so essential to safe investment management.

(c) It is poor collateral, at least at present, in case you should want to borrow on it.

(d) Real estate cannot act as a unit, like other commodities. Property in one locality may be booming while in another, local conditions will hold it down.

(e) Current rents are low, taxes high. Furthermore, taxes are likely to increase with inflation.

Foreign Bonds make a good hedge against domestic inflation if one can feel sure that the gold value of the currency in the country whose bonds are bought, will not also diminish. Today there seems to be no country in the world in which this is certain. American bonds provided an excellent medium for French capital during their inflation and for German capital during the German inflation, but can we be

sure of the franc or the mark, or any other currency today? I fear not.

Foreign Stocks, properly selected, would seem to be a better medium than foreign bonds for the long trend, for stocks would probably be less affected by the decline of the currencies of the countries selected. Furthermore, industry in many foreign countries would seem to be less subject to government interference and excess profit taxes than in America. American stocks afforded French and German capital a satisfactory hedge in spite of the handicap of extremely high stock prices in America at the time their inflation started—1919.

Domestic Common Stocks, carefully selected, would ordinarily afford an excellent inflation defense, particularly as they are now at an unusually low level. The American investor of today would for that reason be much more fortunately situated to combat inflation by holding domestic common stocks, than were the French and German investors, were it not for the uneasiness regarding government expenses and increased taxes.

Commodities, carefully selected with regard to supply and demand, appear to be as good a protection as any against inflation, particularly if a reasonable degree of diversification is observed. Government interference and taxes can hardly be as drastic against corn or copper as they might be in the case of the equities. In the French and German inflations, commodities afforded a very satisfactory hedge, again in spite of the fact that they were at an abnormally high level when their inflations started. With current commodity prices at 30% to 40% of 1918-1919 levels, it is conceivable that this medium may prove to be the protection we should have. There is one feature of holding commodities which the in-

come-hungry type of investor will deplore, namely the lack of dividends. But if he can look back at his 1929-1932 income-seeking experience and still prefer income to protection of principal (or in this instance, protection of purchasing power) well, then he deserves just what he will get, in the event of a material degree of inflation.

The misconception of the public regarding the dangers of inflation, and their tendency to apply methods successful during the last five years, to their problems of the next five years, is clearly shown by the reports of the life insurance companies as to sales of annuities. Never in their history has this department of their business seen such volume—and at the only time in the last seventy years when it would appear to be just the wrong thing to do. The annuitant and the pensionaire, who are planning on a comfortable and money-worry-free old age, are likely to find themselves sadly disillusioned as the cost of living mounts to a higher price plateau and the purchasing power of their dollars is correspondingly reduced.

But let me caution you about several things. In guarding against inflation, don't forget diversification. Commodities, foreign stocks, domestic stocks, in the order named, today look like the best bets to me. But don't limit yourself to one or two commodities or one or two stocks. Ten or fifteen percent of your account in one commodity should be enough; five to ten percent in any one stock. Don't buy on margin. Fluctuations are likely to be too great. And remember, too, that conditions may change at any time, when it may be necessary to alter the plans which seem advisable today.

And one word more:—Many an unskilled investor or investment adviser will tell you that this inflation talk is all poppycock; that this is so, or that is not so, etc., etc. Let us

compare such statements with the words of E. W. Kemmerer, Professor of International Finance at Princeton University. Dr. Kemmerer is known as "The Money Doctor of the World." He has served as financial adviser to Poland, Germany, Mexico, Guatemala, Colombia, the Philippine Islands, the Union of South Africa, Bolivia, Ecuador, Chile, Peru, China and the Dawes Committee.

In his recent book, "Kemmerer on Money,"* he says:

"If, on the other hand, we should make what I believe to be a much more reasonable assumption . . . . then our commodity price level, when once adjustment to 'the new 59.06 cents dollar' has been effected would be as follows: . . . Wholesale prices would be 129% higher than for March, 1934; general prices would be 114% higher, and the cost of living would be 124% higher. *These are the price advances that we may reasonably expect will ultimately have taken place when the depression is over and when the results of the devaluation have completely worked themselves out.* (The italics are Dr. Kemmerer's)

"The above estimates, however, are on the optimistic assumption that the powerful inflationary forces now at work, both political and economic, can be effectively controlled and that the newly established monetary standard can be maintained. If this assumption should prove false, and if inflation should once break away from control and we should have a strong flight from the dollar, prices would rise to very much higher figures."

The investor who scoffs at the probable effects of inflation may know more about it than Dr. Kemmerer, but I wonder.

Your affectionate father,

JOHN GORDON

LESSON NO. 9

Inflation is a dangerous investment obstacle and its effect must be thoroughly understood if the purchasing power of your dollar is to be maintained.

*Published by The John C Winston Co. Philadelphia—$1.50.

Letter No. 10

A DECISION TO MAKE

Chicago, January 11, 1934

Dear Robert:

Before coming to the "Decision," let me tell you just a little about tips, rumors, publicity and propaganda. I hate to insult your intelligence by devoting any space to the subject, but so great a proportion of the public seems to succumb (as I have recounted about myself) that I fear I had better not leave unsaid at least a few words. We have seen in Letter No. 3 how the securities of a sick industry may be shunted off onto the public by clever pool operation. Well, where that is done once with an industry, it is done a thousand times with individual corporations. The late ruthless John W. Gates accumulated a large portion of his fortune in this manner. Director of a dozen corporations, he knew, of course, months in advance when income reports would begin to show serious losses. Long before the news became general even on Wall Street, Gates, under cover of optimistic rumors, tips and pools, would be sold out and on the short side, mercilessly driving down the stocks of his own companies. Then when the upturn was in view to him, his short position would be covered and his long position reestablished, this time to the accompaniment of rumors of bad news. This sort of thing, under the new Securities Act, is supposed to be outlawed, but how tips and rumors can be stemmed, I am at a loss to understand. I am also at a loss to understand how even Gates could be prevented, were he alive today, from conducting such operations through the medium of a confederate. It is already rumored that large

operators are placing their orders in London to be relayed back to New York, thus effectively checking Washington inquiry. Water has a way of flowing around a stone.

The recent Senate investigation, as you may have noticed, uncovered the pregnant fact that certain contributors to financial journals were in the pay of those who wanted to unload weak securities, to the end that favorable write-ups should appear. This practice, too, is supposed to be outlawed. But, commendable as are those provisions of the Securities Act of 1933, let me predict that it will be little safer in the future than in the past to give any credence whatever to the rumors and tips, the "publicity" and the propaganda, which are constantly circulating today, just as they circulated in 1929.

Let me ask you a question. If you were the treasurer or director of a corporation and knew that bullish news was to be released several months hence, would you hand out the information to the first man you met, or would you keep your mouth shut and quietly buy up all the stock you could at the current undervalued price? And, contrawise, if you knew the stock was going down, would you hand out information to that effect? You would not. You would do just what every other perfectly normal, selfish person would do.

But let's get around to the "decision" mentioned at the beginning of this letter. You have seen that first of all you must understand and anticipate major trends of business and of security prices This entails a pretty firm grasp of economics and constant study of such indexes as bank debits, Federal Reserve member bank loans, commercial failures, electric power production, interest rates, construction contracts (dwelling, business, utility and public works), machine tool orders and shipments, automobile production,

money in circulation, freight car loadings, petroleum out put, steel production, brokers' loans, prices of farm products, employment and payrolls, inventories and dollar purchasing power. You must be able to differentiate between the long trend, short swing and day-to-day market movements.

Then you must keep faithful and constant data regarding some thirty different industries. Next, you must evaluate the properties of the leading corporations, some hundred and fifty at least. You must study their capital structures, investigate their managements, determine whether a new bond issue is an offensive move which will improve the prospects of this corporation, or a defensive operation which will retard the prospects of that. You must know what charges for depreciation are necessary in each industry and for each corporation. You must carefully and intelligently weigh the reason for rises or drops in the prices of the stocks and bonds of a hundred corporations and determine when to take a loss and when to hang on, or buy. You must make careful selection between corporations which pay large dividends and those which pay small, realizing that earnings are of greatest importance and dividends of little or none. You must keep your account properly diversified as to types, industries and corporations, and vary the proportions from time to time as factors affecting trends and industries develop. You must not become too enthusiastic, no matter how favorable one company or one group may look, nor must you succumb too easily to the wails of pessimists, for usually the top is near when the optimists are rampant and the bottom passed when the greatest pessimism prevails. You must understand markets and marketability and have up-to-date information as to shares outstanding, shares in the hands of the public and relative activity of several hundred stock and

bond issues. You must be immune to tips, to rumors, to publicity and to propaganda. You must have facilities for fact-finding. You must keep a close contact with Washington as politics is an important factor. You must understand the foreign situation in at least several countries. And, lastly, with inflation threatened, you must understand the five methods of preserving the purchasing power of your dollar and determine which one or two or three of those five will be most efficacious under current domestic and world conditions. Then you must be ever alert for the changes which may make it necessary to adopt a different course.

In short, Robert, you happen to find yourself today at the middle point of a decade more fraught with possibilities of profit or loss to investors than any other similar period since the Civil War. The "Decision" you will have to make is the same I had to make some years ago. That decision is: —"Can you go it alone or do you need help in the management of your money?"

Your affectionate father,

John Gordon

LESSON NO. 10

Disregard absolutely, all tips, rumors, publicity and propaganda.

You must decide whether or not you need investment advice.

Letter No. 11

QUALIFICATIONS ESSENTIAL TO THE SUCCESSFUL INVESTMENT ADVISER

Chicago, February 15, 1934

Dear Robert:

Your letter received and I note your remarks to the effect that you already have sought investment advice from a number of sources and have found them of little or no assistance and sometimes even more of a detriment than an aid. You mention investment bankers, bank and trust companies, brokers, investment dealers, statistical organizations and several investment trusts. You have tried quite a few, haven't you? But don't be too sure, my boy, that some of the fault does not lie with you. Anyone who has lost money is prone to blame his adviser, if he had one. Sometimes it isn't any more the adviser's fault than it is the investor's, although I am not going to deny that a great deal of the investment advice which has been in circulation since the war has been far from good. My own experience has been, after a great deal of thinking on my part—for no one ever *made* me buy *any* security—that oftentimes I had a misconception of the function of the adviser whose counsel I took. Along with that misconception on my part, I have come to the conclusion that many of the people who sold me securities—or at least their representatives—themselves had a misconception of their own function in the complicated investment business.

In discussing these "sources of investment advice," I am going to try to be absolutely fair. I am conducting no defense for the investment business. Neither am I engaged in

muckraking. Mistakes have been made—more often, I believe of the head than of the heart. Instead of unearthing and rehashing these mistakes, it seems to me more the part of wisdom to find out why they are made, so that we can do our part in avoiding future losses because of the same errors.

To get the proper foundation for our study, I believe it is first advisable to determine what we want in an investment adviser. Few investors, I'll warrant, have ever reduced this to a concrete statement.

What I want, and what you want, and what every investor wants, is expert *and* unbiased investment advice. Notice the "and" is italicized. Expert advice is of little use if it is biased in the slightest degree by some other influence. And unbiased advice is likely to be of little help unless it is expert. With this premise, we can now proceed to determine how to judge expertness and to detect ways through which the expert may (consciously or unconsciously) be biased.

It seems to me that we have an almost infallible rule by which to judge investment expertness, provided that the test can be applied in bad times as well as good. Many a good boat sails well with the wind, you know; but isn't worth a whoop tacking its way back, against it. Many a man can run his business in great shape when times are good, but lacks the ability to cope with adverse conditions. Many a half back who doesn't make the first team is marvelous on the offense, but no good in defensive play. This investing game requires both defensive and offensive play, so our test of ability must include bad times as well as good. We are in a very good position for this test right now, after having passed through a serious depression. We're in a much better position than we were in 1929; and better, probably, than

we will be a year or two hence. Your first test of investment advisers then, is the record they have made during the depression and since. If that record is a poor one, then one of two conclusions would seem to be in order: either the adviser is inexpert, or he is biased, perhaps by some influence so subtle that he himself does not realize it.

I have given this subject of bias a great deal of thought and have come to the conclusion that in nine cases out of ten, bias—frequently unconsciously—is engendered by the method of compensating the adviser. This is a selfish world we live in, Robert, and rightly so. As you go through it, you will find that it always pays to look for the selfish motive in men's actions.

If you are to get the best result from any sort of service—be it the service of a lawyer or a tailor—you must pay for it. You must pay well. The chances are that, the better the lawyer or the tailor, the more he will charge you; but you will win more lawsuits and wear better fitting clothes.

This is as far as I shall go this time. I want to devote a short letter to each of the sources of investment advice you have tried, and in those letters will elaborate the "expert and unbiased" idea.

Your affectionate father,

John Gordon

LESSON NO. 11

The successful investment adviser must be "expert *and* unbiased"

Letter No. 12

THE DILEMMA OF THE INVESTMENT BANKER

Chicago, March 13, 1934

Dear Robert:

There is no more misunderstood source of investment advice than that of investment banking, and when I say "investment banking" I refer to the origination of new issues of stocks and bonds—and not to the retail sale of securities which used to be, and properly is, the function of the investment *dealer*.

Twenty years ago, when the purchase of stock and bonds was limited very largely to banks, insurance companies and capitalists, the investment banker was functioning in the capacity in which I believe it is intended that he should function, i e., as the representative of corporations which from time to time were in need of capital. When such occasion arose, the investment banker became the representative of the borrowing corporation. He attended to all the details for the corporation and with a practiced eye on the capital market (banks, insurance companies and capitalists), he recommended a common stock issue, a preferred stock, or long or short term bonds, whichever would best suit the current requirements of his investment-wise market. Thus, if interest rates were currently high and it was to the best interests of the capitalists to buy long term, non-callable bonds, then long term, non-callable bonds were issued. But if interest rates were low and it was to the interests of capital to buy short term bonds, then short term bonds were issued.

But with war prosperity and the liberty bond campaigns, a million, yes several million new investors sprang into being.

These new investors knew little about types, industries or corporate finance. They looked upon the investment banker as some sort of super being who could and would ably direct their funds in the most profitable channels. The bigger the name of the investment banker and the more issues he originated, the better it sounded to the public. They forgot, or never stopped to realize, that the investment banker was still primarily the expert representative of the corporation in need of capital. This avalanche of new investors placed an entirely different aspect upon the situation. Theretofore the investment banker had been treating with buyers who knew just as much about finance as he did, buyers who knew just what they wanted and why they wanted it. Here was an entirely new market made up of millions of individuals who knew nothing about finance whatsoever. What was the logical development? What could it be? The corporations, with experts to guide them—and no fools themselves—soon found that they could dictate the type of security to be sold; that they could get money for five per cent from unskilled investors when experts would demand six or seven or not touch a deal at all; that they could eliminate the non-callable provision in a period of high interest rates; in short, that they could do all of a hundred and one little things which mean nothing to the unskilled investor, but which, taken together, mean a vast difference in his investment accomplishments.

The investment banker alone should not be blamed for this state of affairs. The matter was very largely taken out of his hands. Investment banking houses were springing up like mushrooms. If investment banker X insisted too much upon a better break for investors, the business was promptly given to investment banker Y. The public got what the

corporation wanted to sell, anyway. The fault, if any, with the investment banker, lay in his not advertising to the public that he was primarily the agent of the borrowing corporation. But could you expect him to do that? The fault, in my opinion, rests at least equally with you and me, in failing to realize that the investment banker is, first of all, the borrowing corporation's representative. The interests of the corporation, as a borrower, are diametrically opposed to our interests, as lenders Is not the investment banker likely to be offering that type of security which is favorable to the corporation and therefore unfavorable to the investor? Is he not likely to be financing those industries which are not prospering and are therefore in need of money? Within a given industry, too, is he not likely to be called upon to finance the individual corporation which is in need of capital, whereas the investor might better be buying the securities of corporations which are not in need of capital? There are many exceptions to these assumptions, of course; but it seems to me that the recommendation of the investment banker should be considered carefully in view of his relation to the corporation. I can never forget the statement of a prominent investment banker twenty years ago when, in court, he was asked if he did not realize the difficulties of the New Haven railroad, which had defaulted soon after a large bond issue had been sold. "Of course I realized it," he replied, "but our first duty is to the railroad, which has been our client for fifty years."

There is another influence always bearing upon the investment banker. He pays his rent and his employees from the sale of securities which he can buy and resell at a profit. This method of compensation, it seems to me, is also likely to influence his judgment. He tries to carry a number of secur-

ities on his list to the end of serving the varying requirements of different investors, but when these investors have little idea of what they want or need, it is indeed very easy for mistakes to be made.

The investment banker has still another duty to his other client, the borrowing corporation, of which few investors are aware. As the originator of an issue, he becomes its market sponsor. It redounds to his credit to maintain just as high a market price on that issue as possible. Every bond or share which the public *sells,* helps to depress the market for his issue. What more natural, then, than that the investment banker always recommend that you keep an issue he has sold you? To be consistent he must *always* make that recommendation. He cannot advise half of his customers to sell, without depressing the market for the other half. The logical result is that he always recommends "hold."

Don't misconstrue my meaning regarding investment bankers, Bob This business numbers in its ranks some of the most brilliant men in America; and were I fortunate enough, through relationship or other preferment, to deserve their personal management of my account, I should ask for nothing better. I do not question the expertness of the great investment banker organizations, but I do not believe, in view of the very nature of their business, that they can be unbiased to the rank and file of investors

The investment banker plays an important, necessary role in financing the nation's business. Criticism is seldom heard on the part of investors who realize the capacity in which he serves; who understand the method by which he is compensated and who appreciate his obligation, as a sponsor of his issues, to maintain the best market possible for them. Trade with him if you know what you want, but my feeling is that

there ought to be a buffer between the big investment banker and you—someone to whom you can at least give the devil if an issue goes sour; someone who, if an issue is weakening, will at least have no objection to your selling it.

Now, Robert, let's see how our system is working:

Record: Your investment banker's record has not been good.

Probable reasons:

(1) He is primarily the representative of the borrowing corporation.

(2) His method of remuneration is not conducive to his sole interest in your welfare.

(3) His interest in maintaining a good market for his issue precludes his ever advising you to sell.

Your affectionate father,

JOHN GORDON

LESSON NO. 12

The big originating houses are likely to be biased because of their representation of the borrowing corporation; because of the method by which they are remunerated, and because of their obligation to maintain a good market for their securities.

Letter No. 13

BANKS BACK TO BANKING

Chicago, April 17, 1934

Dear Robert:

"Ask your banker."

By "banker," I mean the commonly accepted use of the term—the commercial banker.

When the bankers (for I presume they started it) began to use the advertising slogan, "Ask your banker," I am sure they had in mind questions regarding the conduct of the customer's business, his local real estate investments, etc. Why or how the commercial banker should or could be credited with omnipotence in problems of investment management, has always been a puzzle to me. I believe, too, that most good bankers were loath to accept the responsibility of giving investment advice to their customers. But the public, ever prone to idolize, especially if the subject be quartered amidst marble and mahogany, practically forced them to, regardless of their own wishes in the matter. The banker might say, defensively, "Oh, yes, New York Central is a good stock," but if asked why he thought it would perform better in the future than duPont, he would probably display his hands palms up and shrug his shoulders.

As a matter of fact, running a commercial bank is quite a job in itself; and it has little more relation to the administration of a private investor's account than has the operation of a pawn shop. All three deal in dollars, but that is about as far as the relationship goes. The commercial banker is chiefly interested in determining whether your note is a good security to accept in exchange for $1000 of his depositors'

money After that he is interested in finding a source of investment for his surplus funds, for which the ever important consideration is constant liquidity and immediate marketability. If it were a fair question, I should be very glad to get a good banker's opinion regarding the "cash equivalent" portion of my investment account. But I do not consider it a fair question, because his third interest is in getting me to use his bank for that portion of my account.

Furthermore, in his bank's investments, the banker is aiming at an entirely different mark than is the private investor. The banker's liabilities are all in dollars, i. e., when you deposit your money with him he agrees to pay so many dollars The private investor's problem is entirely different, although far too few investors realize it. You are saving your money for what it will buy for you or your heirs. Prices of things change, as you have seen in my letter on inflation. A $10,000 house or a $2,000 voyage around the world which you have your eye on today may cost you twice as much five years from now. If you invest the same way the bank does, you are likely to be badly disappointed. We have seen, in our study of inflation, how important it is to maintain your dollar purchasing power. The above examples serve again to illustrate how far apart are the problems of bank investment and individual investment.

I am sorry, and I am sure the bankers are, that they ever stepped out of their own province to engage in the investment business, either directly or through the media of investment company affiliates Prior to that misstep, the banker could at least say that he didn't know; but, in the investment business himself, and with a list of securities to sell, he could not very well dodge the responsibility of extending his

advice, good on local matters, to include a subject for which he was, to say the least, poorly prepared.

But that is all over now. The new banking act forces the separation of all investment affiliates from their parent banks and leaves at least the *national* bank out of the investment business, except for municipal bonds. The wise banker will do well to avoid the sale, even of municipals. The new law, restricting him as it does to a single type of security, is going to lead many of them into unsound advice to individual investors just as surely as commodity prices rise and fall—which they are always doing.

Another objection I would have to taking advice from commercial bankers is that they are not paid for giving it.

Record: Not good.

Probable reasons:

(1) His training is toward a different end from that which you must achieve.

(2) He might be biased because he wants you to keep your money in his bank.

(3) He is not adequately paid for advising you.

(4) Under present restrictions, if he wants to earn commissions he is limited by law to one type of security.

Your affectionate father,

JOHN GORDON

LESSON NO. 13

The commercial banker's training and experience have been toward a different end than that which you seek; he naturally wants you, in normal times, to keep your money in his bank; he is either improperly or inadequately paid for advising you; and the *national* bank now has but one type of security to sell.

P. S. As to Trust Companies, I presume you referred to "Bank and Trust Company" as a single institution. The record of the one seems to parallel that of the other. From what I know of Trust Company management, I am inclined to believe that the Trust Companies should, and some day will, confine their operations strictly to the "Trust" business, i. e., the safekeeping of securities, collection of income, etc., leaving investment management to those proven more competent.

If you care for additional information regarding Trust Companies, you might read "How to Lose Your Money Prudently" by Fred C. Kelly. Roland Swain Company, Publishers, Philadelphia—$1.50.

Letter No. 14

THE BROKER'S FUNCTION MISUNDERSTOOD

Chicago, May 12, 1934

Dear Robert:

The broker's fee for completing the purchase of a $1,000 bond is $2.50, or ¼ of 1%; for selling 100 shares of Telephone, a $10,000 transaction, it is $25.00, or approximately ¼ of 1%. When you consider the various hands through which an order must pass, the capital required, the wire expense (from cities other than New York), the accounting—not to mention salaries, rent and numerous other items of expense—you will realize that there cannot be much left out of that $2.50 or that $25.00 to pay the broker for advising you.

As a matter of fact, he doesn't pretend to advise you—at least, no reputable broker does, and never has. The broker's function, and his sole function, is to provide the mechanics for completing your purchase of the $1,000 bond or the sale of your telephone stock. Unfortunately, and due again at least in part to the insistent demand of a non-thinking public, the impression became almost universal that the broker could and would "tip you off" to something good. Supply appears where demand occurs and it was not long after the advent of millions of tip-hungry investment neophytes that the brokerage office became, not a source of investment advice, but a breeding ground for tips, rumors, publicity and propaganda. Impelled by the ever increasing demand for "inside information," the brokerage business was soon employing "customers' men," whose duty, the broker has always said, is to write up orders for customers

and assist those unacquainted with the mechanics of the business in placing their orders. But the public did not, or would not, construe it that way. The customers' man became a demigod, second only to the managing partner. So thoroughly misunderstood a relationship could result in but one thing. I assume that your unfortunate results with your broker are founded upon your misconception of the broker's function, together with his failure to tell you that he and his customers' men know little more about it than you do.

I believe it is that irrepressible Wall Street wag, perennial Bawl Street Journal Editor John A. Straley, whose flow of wit not even the depression can still, who has said: "Were all the customers' men in the country laid end to end—it would be a great thing for the country." John ought to know. Unless I am incorrectly informed, he has been one.

The broker, too, has another drawback as an investment adviser. The success of his business depends, more than anything else, upon turn-over. A $1,000 outright purchase by you is scarcely worth his trouble: but if you will use that $1,000 as margin to make a $3,000 or a $4,000 purchase and then in a few weeks or days or hours, sell out that stock and buy another—then your account becomes worth while. It is in this way that tens of thousands of small investors, and large ones too, became "traders," matching their part-time wits against the shrewdest men in the investment world—men with years of experience in trading; men who know oftentimes what is going to happen in a given industry or a given corporation, while the novice guesses; men whose stock exchange membership enables them to trade without brokerage commissions. There could and can be but one result It is the old story of an experienced, highly intelligent, expert few against an unorganized, untrained rabble.

To me there is nothing more pathetic than the crowd of hangers-on in a brokerage office Pointing at the tape, nudging each other, "I told you so," nodding sagely, excited at a .971 point rise in the averages, depressed at a .423 point drop; eager, hopeful, sad, distressed—and always *sure* to lose their money. Telephone calls to the broker are nearly as pathetic. Jones, the manufacturer, would never think he had time to telephone his wife or call up an old pal for a friendly chat; but several times a day, he can call his broker to ask, "How's she going, Bill?" "She" being the market. Or "What's Radio doing?" "Or Can?" "Or XYZ?" Pathetic!

If you must "take a fling" occasionally, Bob, I hope you will observe the following simple, sensible rules:

1. Use only a part of your capital, preferably not to exceed 20%. 10% would be better. You'll have just as much fun and lose only half as much money.
2. Remember that the market is most dangerous when it looks most inviting; and least dangerous when it looks the worst
3. Remember that 95% of the crowd buys at the top and sells at the bottom.
4. Don't worry about profits you might have made. There are more people suffering from "hindsight trouble" than from sinus trouble.

Properly operating as such, the broker renders an indispensable service in executing the buying and selling orders of customers who know what they are doing It cannot be expected of him that he will be his customers' adviser.

Record: Not good.

Probable reasons:

(1) He is neither adequately paid for, nor equipped to give, investment advice.

(2) He is likely to be influenced by the desire for more trading.

Your affectionate father,

John Gordon

LESSON NO. 14

The broker does not pretend to give investment advice; and he is neither adequately nor properly paid for it.

P. S The possible bias of the three sources of investment advice which I have covered so far has been recognized by congress in the Securities Act, the Banking Act and the Securities Exchange Act. The investment banker is limited in his sales talk to the prospectus which must be passed upon by the Federal Trade Commission. The national commercial banker is returned to the sphere which by training and experience he is fitted to fill. A sincere effort has been made, in the Securities Exchange Act, to prevent the broker from giving investment advice. While it is very difficult to legislate protection for an uninformed investor, he has obviously been warned by the government that these three sources can hardly be expected to render him expert *and* unbiased investment advice.

Letter No. 15

SHOULD STATISTICAL ORGANIZATIONS STICK TO STATISTICS?

Chicago, June 5, 1934

Dear Robert:

This is a source of investment advice which has keenly disappointed me. It is distinctly out of the "tipster sheet" class and supported by years of faithful service in the compilation of statistics Along with many other investors, I thought here was a source that would be both expert and unbiased But I was mistaken and disappointed as evidently you too have been. However, upon considering these organizations carefully and after giving a great deal of thought to their problems, I have been able to assign several logical reasons for their ill success.

Their first handicap, it would seem, is that they were designed for, and operated years and years solely in the compilation of statistics Statistics is the recording of what has happened. Investment management, while it uses statistics, is very largely the foreseeing of what *will* happen. I am convinced that these organizations, steeped in their own specialty, give far too much weight to the experience of the past They can say all they want to that "History repeats itself." Were one to grant that it does, he would be forced to admit that the repetition is usually accompanied by manifestations and phenomena little akin to those supporting the historical event. My experience has been that about the only thing you can be sure of is the certainty of change. The first explanation then for their unsatisfactory results is that they

probably allocate too much weight to statistics in making their prognostications.

It sounds easy to "add another department," (i. e., add the giving of investment advice to the compilation of statistics), but many a business man has found that the new department fails unless he gets a manager of the very finest calibre. A physician might easily, one would think, add dentistry to his practice and employ a dentist to do the work, but I imagine the calibre of dentist he would want, would prefer to have his own practice instead of operating under the wing of the other profession. Businesses and professions become saturated with the lore, the customs, the temperament and the atmosphere of their background. It is hard indeed to break away into a new department which is so radically different from the parent business or profession, as is foreseeing the future, compared with recording the past.

The next handicap I can see for the statistical organization is the vast amount of unnecessary ground it must cover —that is, unnecessary for the purpose of conducting a sound investment management program. The very nature of the foundation business—statistics—in order to satisfy a country-wide clientele, demands the preparation of statistics on several thousand corporations, around thirty thousand currently, I believe. Obviously, no great amount of time can be devoted to each one Compare with this scattered fire, the operations of an investment management which properly limits its intensive studies to 150 individual corporations Compare it with the six months' work of an expert research analyst and several assistants on a single corporation. Compare it with the intensive study of economic and industrial trends by able investment management. Then you begin to

see why the expert and unbiased investment manager has been able to achieve far superior results.

The general effect, if you have ever been through one of the mammoth statistical organizations, is that of a boiler factory. Hundreds of typewriters clicking and banging and ringing, messengers rushing from this office to that; from the seventeenth floor to the fifteenth and down to the sixth and up to the sixteenth. The *organization* is marvelous. The reports must be out on time! My one experience with the office of a statistical giant was very amusing. I wanted some information regarding the Chesapeake and Ohio Railroad. After subscribing to a service that would entitle me to this information (cost, $150), I was passed from Mr. A to Mr. B to Mr. C, and was finally conducted to a Mr. Z. Mr. Z spent the first ten minutes selling me on the organization, but presently we got down to my business. I happened to remark that the C & O was a Van Sweringen road to which Mr. Z demurred. I pressed my point, however, and Mr. Z finally reached for his "railroad manual." "Yes," he said at length, rather testily, "it is a Van Sweringen road, but what of it?" I went back for my $150, but it was too late. I had signed up for a year.

Another difficulty for this kind of "service" is that they must get out the weekly letter on "Friday night or bust." Thousands of subscribers expect it. They demand it. It must get to them whether there's anything to say or not. This necessity to say *something* to a waiting public must be very trying. It is my firm conviction after watching the investment advice of statistical organizations for a number of years and after being shown around a "plant" that they are too ponderous and unwieldly; that they are too much sales organizations, catering to the untutored demands of unskilled

investors. The first function of able investment managers, in my opinion, *should* be to do just what I am trying to do for you, i.e., inform you as to the proper methods to be employed in the selection of types, industries and individual corporations; to teach you that short swings and weekly fluctuations are a snare and a delusion—instead of slaking and provoking your ill advised thirst by feeding you a steady stream of current recommendations and short swing prophecies The methods of the statistical organizations have the appearance of another situation where the supply is in answer to the popular demand, rather than a sincere effort to correct the misconceptions of a public born in investment error.

Typical of statistical organizations' forecasting blunders is the following from a "weekly letter" published in March, 1931:

"We do not believe that a further reaction in stock prices, at this date, would signify any change in the broad upward trend of the market and we would consider such an occurrence as representing a buying opportunity"

Contrast with the above, the written statement of a prominent investment manager in April, 1931, to one of his clients:

"We believe that realities alone justify a lower price level for the national equity. Beyond this, we feel that increasing overpessimism will force stock prices still lower to a level which is in fact not justified. So far as we are concerned, we continue to wait until we can better understand and more accurately interpret certain underlying and fundamental trends."

As everyone knows, the stock and bond markets continued to decline for fifteen months after these two prophecies were made.

Another pathetic picture to me is the crowd you see in the "statistical rooms" of brokerage and investment offices and in "business libraries." I have looked over the shoulders of hundreds of these poor investment-information-hungry souls and always they are poring over balance sheets and income reports, comparing the "five year earnings" of this company with that, or scanning the "weekly letter," hoping to "pick a winner." The pathetic part to me is that none of them know they are ignoring the two most important steps of investment management: first *type* and then *industry* selection.

My feeling is that the sooner the statistical organizations follow the lead of the banks and confine themselves to the business for which they were designed—just that much sooner will the investment business begin to get on a better foundation.

Record: Not good.

Probable reasons:

(1) They were designed and have been operated for many years as compilers of statistics and not as investment managers.

(2) They must spread their efforts over some 30,000 corporations.

(3) They are obviously catering to the demands of the public for prophecies of short swing movements instead of teaching the public that short swing movements cannot be prophesied.

Your affectionate father,

JOHN GORDON

LESSON NO. 15

Statistical organizations are primarily compilers of statistics. They have to cover too much ground in reporting on thousands of corporations They are forced to cater to their subscribers' ill-advised demands for short swing prophesies.

Letter No. 16

INVESTMENT TRUST TROUBLES

Chicago, July 27, 1934

Dear Robert:

The investment trust is another source of investment advice in which I have been disappointed, as you too have been, for I note your reference to "several investment trusts." There have been a few good investment management records among the trusts—but too few. Their general ill success can be traced to their failure, for one reason or another, to observe the principles discussed in Series I of these letters (first four letters); and their failure to avoid, for one reason or another, the mistakes and misconceptions covered in Series II. (Letters 5 to 9, inclusive.)

I want to define an investment trust. It is, or should be, an investment vehicle through which the investor will secure (1) broad diversification, and (2) the investment management which he so sorely needs. American investment trusts have qualified as to diversification, but many of them have been woefully weak as to investment management. Let us see if we cannot find out why. Roughly speaking, we may say that there are three classes into which all investment trusts will logically fall: (1) general management trusts, (2) fixed trusts, and (3) restricted management trusts.

The General Management Trust

The general management trust was the first to develop in the American market. A very few made their appearance in the early twenties. Several more were brought into being

in 1924 and 1925 but it was not until 1928 and 1929 that the general management "trust business" came into its greatest popularity. It was unfortunate both for the trust movement and for the investor that this development should come at the very peak of the long trend 1921-1929 rising market. It was unfortunate for the trust managements because they largely ignored trends. Hardly had they started when the 1929-1932 bear market began. Ignoring trends as they did, it was of course inevitable that their management record was to show a serious drop from almost the moment the investor's money was placed under their supervision. The record of management results for most of the 1924-1925 crop showed a steady climb from their beginning for four or five years, before a change in trend occurred. I say it was "unfortunate" that so many trusts were organized in 1928 and 1929. Fortune should be but a small factor in investment management, but we hear general management trust sponsors talk of being "victims of the depression." They were victims of the depression for one and only one reason. They ignored, or refused to consider, or were unable to detect *a change of major trend.*

But even this failure of management is not what brought the general management trust into its full disfavor. Unfortunately, there were abuses—in some instances outright betrayal of the fiduciary responsibility which falls upon the man or organization which sets itself up as a manager of other people's money. Muckraking, as I have said, is not the purpose of these letters. If you wish to inquire into the abuses of that day, you should read "Investment Trusts Gone Wrong," by John T. Flynn.* Another able discourse on investment trusts will be found in a pamphlet entitled, "The

* New Republic Inc, New York—$1 00

Investment Trust Yardstick."* For our purposes suffice it to say that most of the abuses in the general management trust were among those managed by investment bankers, who were originating, and who had for sale, other securities. Not in all cases by any means, but in a great many, the severe drop in the share price of the general management trust was due to the "unloading" into the trust of these other originations, which the offending houses found difficult to sell to the public. It was the realization on the part of the public that they were being taken advantage of that caused the swing of popular favor to the fixed trust.

The Fixed Trust

The fixed trust, confining itself as it does, to a single type of security (usually common stocks) is, of course, unthinkable to anyone who has any knowledge either of the record of the fixed trust, or of "What Constitutes Investment Management." The fixed trust is another example of the lack of understanding of investment principles by the investors who bought them. I am sure no one ever claimed anything for them except "a conventional list of high grade stocks." Starting at almost the peak of the long upward 1921-1929 trend, the shares, of course, reflected the precipitous 80% drop in common stocks prices from 1929 to 1932. The fixed trust ignores entirely every essential consideration in the successful management of money—(1) fitting types to trends, (2) the changing conditions of the various industries, and (3) the changing fortunes of individual corporations.

The Restricted Management Trust

I do not like the "restricted management" trust. It would seem to be but another appeal to the "ignorance, fear and

*Gile Press, Minneapolis—$1 00

misconceptions of the untutored investor." With investors frightened and disgusted with the abuses of the general management trust, and then undeceived as to the wisdom of the fixed trust, the sales sense of the professional trust "sponsor" develops a middle course, the "restricted management" trust! Let's consider that term for a minute—"restricted management." The use of the word "management" implies and admits that "management" is needed to safeguard the interests of the investor, just as the word automobile implies and admits that wheels are needed to ride from one place to another. By including the word "restricted," the "restricted management" trust says that the brake should be partially set because its management cannot be relied upon to drive the car up and down the "long trends." It says that the chauffeur is so incompetent that he cannot be trusted to get off Utility Boulevard when he sees the twin busses "government competition" and "inflation" charging at him. It says that he cannot even be trusted to change a spark plug or a tire without writing home to see if it will be OK. That is the way these "restrictions" appeal to me, Robert. Either you need a chauffeur or you don't. If you do, then employ one who has proved by his record that he is competent to drive your car. Such restrictions as the provision that only one change a year can be made without the approval of the shareholders, or that 51% of the stockholders must approve portfolio changes, ought to make the managers blush at the implied admission either of incompetence or untrustworthiness. It may be, on the other hand, a preparation for a repetition of the fixed trust sponsors' excuse, i. e., that they couldn't get out of the market because the terms of the trust indenture provided that they must be at all times invested in common stocks. Now that the record of the re-

them with inexpert management? Whichever our decision, we approach the conclusion that what the investor needs is expert *and* unbiased management.

The Compensation Influence

Another prevalent bias factor is the method by which an investment management is paid. We have seen that investment advisers must be paid, and well paid, if they are to render good service. But *how* they are paid is also important. And here is where I believe a number of investment trusts have erred. There are three methods of payment, not including those trusts which charge no management fee.

(1) A percentage of the profit made annually;
(2) A percentage of the annual income;
(3) An annual percentage of the amount of money in the trust.

No. 1, a percentage of the annual profit, gives a speculative incentive to the management. If large profits are made, the management stands to make a killing. The natural result is that unwarranted risks are likely to be taken.

No. 2, a percentage of income, also gives a wrong incentive. Little income to the investor would mean little pay for the managers No management can afford the expense of fact-finding and research without pay, as I shall prove to you in a subsequent letter. The result is that a management which receives a percentage of the income must "invest for income" if the said management is to be paid. We have seen in Letter No. 6 how costly it may be to "invest for income."

No. 3, an annual percentage on the amount under the direction of the investment manager, is the only method by

which an investment management should be paid. I shall discuss this, too, in a subsequent letter.

Reviewing the investment trust, we can draw the following conclusions:

Record: Not good.

Probable reasons:

(1) The "fixed trust" and the "restricted management trust" are doomed to unsatisfactory results because of defects in the vehicle itself.
(2) Investment banker management.
(3) Management by those whose chief interest centers in, and whose major profit comes from, the sale of shares in the trust.
(4) An improper method of compensation.
(5) Incapacity of management.

Your affectionate father,

JOHN GORDON

LESSON NO 16

Fixed and restricted management investment trusts cannot succeed as investment managers because of structural imperfections.

Management trusts are frequently directed by those primarily interested in sales

The method of compensation for investment management is sometimes on the wrong basis.

Letter No. 17

INVESTMENT DEALERS

Chicago, August 13, 1934

Dear Robert:

It seems to me that the local investment dealer has the opportunity of his lifetime to assume his logical sphere in the distribution of investment securities and (which is more important) the opportunity to become an important factor in the dissemination of investment advice. The local dealer could never get away with the claim to omniscience and prescience by which most of us were deluded in the heyday of the New Era. Unlike the big banks and originating houses, he had no great names on his board of directors who would, by inference, lead the investor through the lane of safety to the beautiful meadow of easy profits.

It is perhaps unfortunate for him, Bob, that you and I know our local investment dealer or his salesman so well. We have been in his office. We know just what it is and what it is not. Too often, I fear, we are tempted to underrate him because we meet him so frequently and know him so well We have not realized that the very fact that this man must meet us face to face—day in and day out, month in and month out, year in and year out—is a most important circumstance in his relation to us as an investment adviser. The great originating houses, representing as we have seen, the interests of the borrowing corporations; the great bankers, whose investment affiliates are now unaffiliated by law; the great statistical organizations; the brokers' head offices; the investment trust managers—all are far, far away—safe from our impotent wrath. But the local dealer is still here

This is no apologia for the local investment dealer. He has made many mistakes and has been forced into many more, in my opinion, by the combination of skillful big name propaganda and untutored investor demand. But we cannot deny that the necessity for the local dealer to meet us day after day is a most important factor toward his sincere interest in our behalf.

I don't like the heretofore universal method of local investment dealer remuneration, but that is rapidly changing. More and more local dealers are reconstructing their business, in part at least, on a basis whereby their method of compensation is not a deterrent to unbiased investment advice. More and more are getting their information from sources which are far superior to that of other, heretofore discussed, more biased advisers. I shall discuss this at greater length in another letter.

Local investment dealers and their salesmen can be divided into two classes: (1) those who think, and (2) those who do not think. The latter group has come through the depression, little better investment advisers for the experience. The former thinks and studies. They have seen the error of disregarding the fitting of types to trends as discussed in my letter No. 2. They see the vital part that industry studies play in a successful investment program (Letter No. 3). They understand why and when to take losses and why not and when not to take profits (Letter No. 5). They are not misled by "The Erroneous Conception of Income," covered in letter No. 6. They can intelligently discuss inflation and the several ways for the investor to protect himself against it. (Letter No. 9). They now know the qualifications essential to the investment adviser (Letter No. 11) and the handicaps of investment bankers, commercial bankers, brokers, statistical

organizations and investment trusts (Letters 12 to 16). In short, the depression-experienced local investment dealer or salesman, who is making the necessary changes in his method of operation, is rapidly finding out what we should have *and how to provide it for us.* This type of dealer or salesman is no longer going to be used as a channel for selling us something we should not have, and the purchase of which will spoil us as customers.

Test your local dealers or salesmen. Draw them into a discussion of the subjects mentioned above. Fifteen minutes will be enough to tell you whether you want them as investment advisers.

Your affectionate father,

JOHN GORDON

LESSON NO. 17

The local investment dealer or salesman whom you know, if he is a thinker and a student, will probably be a better investment adviser than many of the sources we used to believe were far superior. He still has the handicap of an improper method of compensation in many instances, but this is being rapidly corrected and is largely off-set by his personal acquaintance with us His ability can be easily tested by half a dozen questions

Letter No. 18

NAME IT WHAT YOU WILL

Chicago, September 20, 1934

Dear Robert:

It makes no difference by what appellation we designate the source of expert and unbiased investment advice. I would just as soon get good advice from investment bankers or brokers or statistical organizations, if they could give it, as from investment administrators, or investment counsel or investment managers. The name makes the adviser no more than clothes make the man.

What you and I are interested in is, first, *unbiased* investment advice We know it cannot be good if (as noted in our discussions of several sources) the authors of that advice are biased by influences which pull against our own financial well-being.

As you have seen from my letters, I have leaned toward the title "Investment Managers" as typifying that which the investment adviser should be able to do for me. "Investment Counsel," however, is perhaps a designation which is beginning to be just as well or better known. In his excellent treatise, "The Practical Application of Investment Management,"* Dwight C. Rose tells of the origin of the "investment counsel" movement, as follows:

"The need for investment counsel was first met in a practical way in the year 1919 when a small firm of investment bankers decided upon a fundamental revision in the usual relationship with customers A careful analysis of the results accomplished over the preceding years initiated this move. On the whole the firm's customers had done reasonably well because the partners

*Harper & Brothers, New York—$2 50

had tried not only to sell securities on which the firm could make a satisfactory profit but also had endeavored to build up and maintain for each customer a sound financial program, including the purchase of many securities on which the firm did not make a profit.

"When, after two years, the results were carefully analyzed, it was found that those securities on which the firm had made a profit—and which they were practically forced to sell in order to eke out a living—had worked out relatively unsatisfactorily to their customers. Those securities on which the firm did not make a profit, however, had turned out exceptionally well. The partners thus reasoned. 'If we could buy for our customers just those securities that we would select on the basis of their investment merit without consideration of our selling commissions, we could do a much better job, but how could we make a living out of it'?"

The plan tried first was that of adding an agreed percentage fee to each purchase; but feeling that this plan might harbor an influence toward unnecessary sales and repurchases to earn another commission, it was soon changed to an annual percentage charge on the amount of capital under the direction of the firm. Thus the sinister influence of profit from the sale of securities was removed from this source of investment advice. *To me, this is the greatest step forward in the investment business that has ever been taken.*

We have seen that the investment banker is influenced by his commission on the sale of securities, in addition to his representation of the borrower. The banks, to the extent that they are still in the investment business, and the brokers, must fight against this self-interest, "eke out a living" influence. The statistical organization has it, too, indirectly, in its compulsion to maintain income by filling the popular demand for short swing prophecies. The investment trust, whose investment management is under the control of those

whose chief income is derived from share sales, must also struggle against the inclination to manage the trust so that it will appeal to the misconceptions of prospective purchasers, rather than to manage it in the best interests of those whose capital is already in the fund.

By the simple device of putting their compensation on a basis where they are paid for competence in managing money, rather than for competence in making sales, investment counsel, or investment managers, or investment administrators, or whatever you may wish to call them, have eliminated the greatest handicap to successful investment management. If financial success, to a source of investment advice, depends upon salesmanship, then naturally able salesmen will dominate that source. If, however, the sales factor is eliminated and financial success depends upon the record of investment management, then naturally, able investment managers will dominate that source. It remains for the public to demand a record of successful investment accomplishment. That a goodly number of investors have already demanded it, is borne out by Rose's statement that a number of billions of dollars are now under investment counsel management.

Here's another example of how easily selling commissions may dominate the seller of securities, if he isn't careful:—I was surprised several months ago when an investment dealer, a personal friend whom I consider an extremely competent man, offered me some municipal bonds. I asked him what he thought about inflation. His eyes lighted up and he replied: "I ought to be concerned about it. You ought to be. We all ought to be. But it is so hard to explain and the public is so avid for municipals that frankly we are just floating along with the tide, offering what the public wants

to buy, instead of having nerve enough to tell them what they ought to have and proving it to them."

But let me warn you here, Robert, that the mere declaration of an individual or a firm or a corporation that they are investment managers or investment counsellors, will not, in itself, make them investment experts. The larger cities are already teeming with good salesmen turned "investment counsel" over night, to meet the growing investor consciousness that sales and investment management do not go hand in hand. Other organizations, dominated by salesmen, have set up dummy "investment management corporations" to lend the appearance of unbiased investment management; but such "investment management corporations" are really under the thumb of the sales managers and still pursue investment policies calculated chiefly to appeal to the misconceptions of the untutored investor. There is an unfailing test which anyone can apply, which I will explain to you in my second letter after this one.

Your affectionate father,

JOHN GORDON

LESSON NO. 18

Investment advice, to be thoroughly unbiased should be disassociated from the sale of securities. The investment adviser must be paid for advising—not for selling.

Letter No. 19

THE ORGANIZATION ESSENTIAL TO SUCCESSFUL INVESTMENT MANAGEMENT

Chicago, October 10, 1934

Dear Robert:

This story which I pass on to you, was recently told me about the investment holdings of a private investment fund. I believe it is true, for the man who told me was a trustee of the fund. It seems that this fund maintained quite an elaborate organization for research and investigation purposes; and one of their research groups had just completed a six months' study of a certain corporation in which the fund was a heavy investor. The research man, at a meeting of the trustees, had made his report which was to the effect that this corporation —and the industry which it represented—had passed their prime and would be on the way down, for a number of years at least. The trustees, big business and professional men all, were loath to place much credence in such a report on one of the greatest American corporations. One of the trustees, a millionaire, and a dominating and domineering man, demanded of the research man, "Are you sure of this? Might you not be mistaken?" The research man, uneasy in the presence of so much wealth and greatness—and distinctly not the salesman type—replied quietly that, of course, he might be mistaken, that certain other factors might develop which would change the course of events as he then saw them. "I thought so," grunted the millionaire. The upshot of the meeting was that several dinner engagements were made and several golf games arranged in order to contact officers and directors of the corporation under discussion.

At the next quarterly meeting, all reported that there was nothing to the fears of the research man; that the corporation and the industry under consideration were in splendid shape and "never looked forward with more confidence" to the future. The investment was retained. The fund lost $1,000,000. The research man's report proved to be astonishingly correct Had the trustees worked with this research group through its intensive six months' study; had they seen, step by step, how the conclusion was arrived at, their decision might have been a different one. Expert *and* unbiased advice might have been taken instead of "inside information." The experience served a purpose nevertheless, for since that time the research man's advice is followed, officers' and directors' statements and opinions to the contrary notwithstanding.

I tell you this story with the aim, if possible, of disabusing your mind of the common fallacy that "inside" information is to be gotten from directors, officers—"big names." It just isn't "in the wood." Generally they are so close to their own company and their own industry, so absorbed in their plans and efforts for its upbuilding, that their opinion unconsciously is biased. And then these men are not fools either. Suppose they did realize that their company was facing trouble. They might be unloading a little stock themselves. To have such a fund drop a large block of stock on the market would lessen their own chances of feeding out their own stock at as high a price as possible. It is another instance of free advice—worthless.

A revelation to most investors will be Mr. C. P. Keane's* assertion in his "Investment Diagnosis:"

> "I am advised that the majority of clients of the leading Investment Administrators are our corporation leaders, men who hold many important industrial and financial directorships.

*Publisher of Keane's Manual of Investment Trusts and other financial reference books

"Such men, you would reason, represent exceptional business acumen in their own right. They, least of all, you would say, have need of independent investment advice Yet it seems no one so highly estimates the value of outside aid as the investor whose opinions are so much sought after."

Another expression of opinion by those high in the councils of an industry is a matter of record in the "WORLD'S BUSINESS" of September 1930. Under the caption of "A Promise of Better Things," this business magazine quotes the statement of the finance committee of the United States Steel Corporation: "The corporation is acting at 63% of capacity and," says the committee, "indications in the industry point to an increase in this rate of operation during the balance of this quarter with an improvement in volume during the last quarter of the year."

Then WORLD'S BUSINESS goes on to say editorially, "If the Steel Corporation goes ahead, all business goes ahead; and when one reflects that the committee just quoted includes such men as J. P. Morgan, George F. Baker, Senior and Junior, Thomas W. Lamont and James A. Farrell, he is bound to believe that the statement is based on a sound understanding of what is going on, and a keen vision of what is to come."

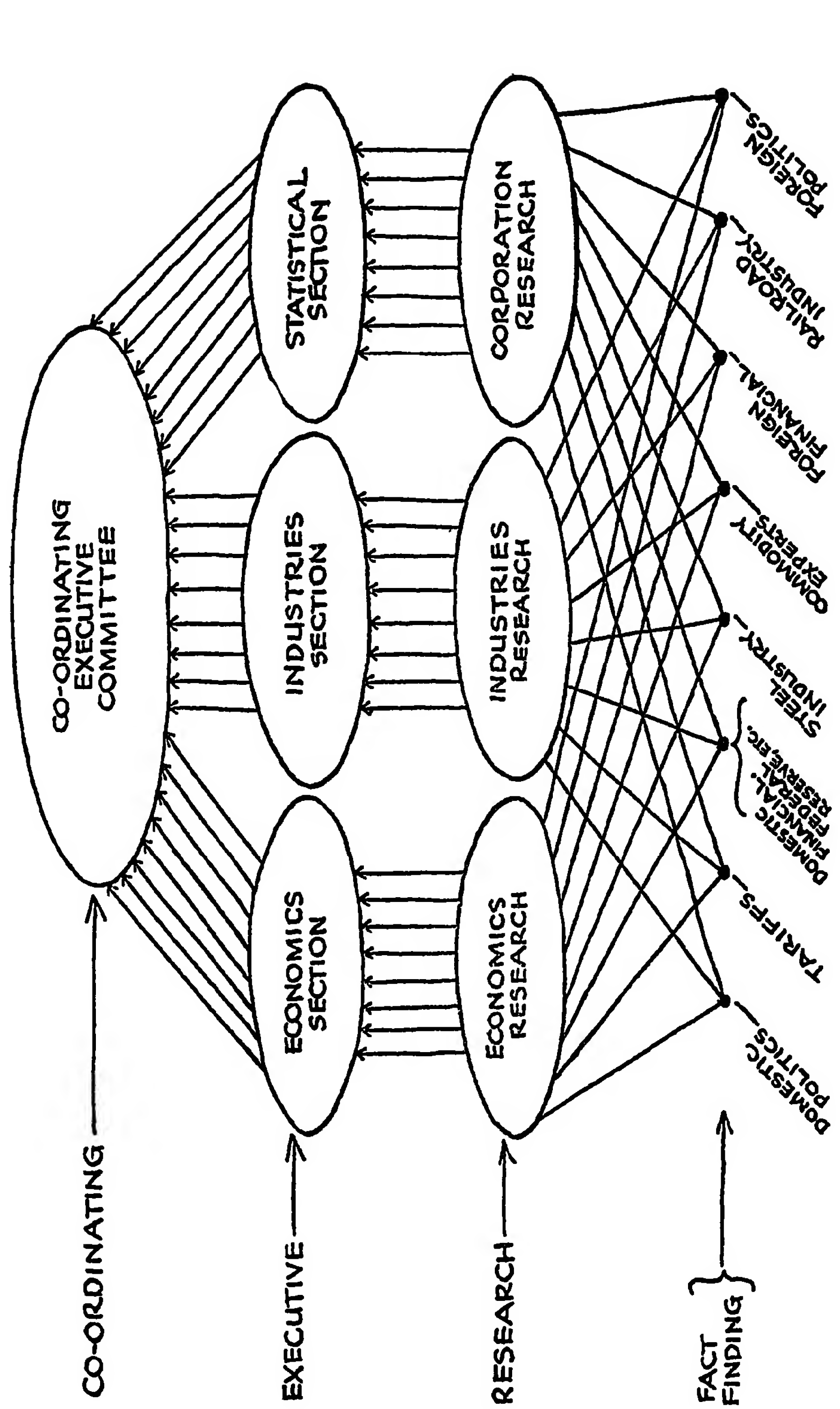
What actually happened was that the rate of operation, not only of the Steel Corporation but of the entire industry, declined steadily from the date of that prophecy to the end of the year when it was acting at 30% of capacity! This letter is being written four years later and not yet has steel operation again reached 63%. At the very time Steel's finance committee was prophesying a higher rate of activity, able, unbiased, expert investment managements were

disregarding the committee's statement and staying out of steel industry securities.

The necessity for fact-finding and research which we see in the above two examples proves again too, how essential is the proper method of investment management compensation. Not only must investment management be paid, for managing instead of selling, but the method of payment is important Payment either by the "percentage of profit" or "percentage of income" methods, as I have mentioned in a former letter, is likely to leave the investment manager with little or no compensation during the periods when profit or income to the investor are inconsistent with conservation of principal. An investment management should be able to plan on a reasonably definite sum, year in and year out, if they are to maintain their fact-finding and research departments on a scale which is essential to the attainment of good results. The only method which will assure continuity of income for these purposes is an annual percentage on the amount of money under the direction of investment managers.

And now I want to give you a birdseye view of the organization which is essential to expert and unbiased investment management. The first requirement is that the management be paid, well paid, and paid a percentage of the amount under its direction. With a substantial volume of capital under its direction, the management is thus enabled to support its activities regardless of temporary income or profit to you and me. Research and fact-finding are even more important in a period of depression than when business generally is prospering.

The next condition to expert and unbiased investment management is that such management shall be precluded


CO-ORDINATING
EXECUTIVE
RESEARCH
FACT FINDING
CO-ORDINATING EXECUTIVE COMMITTEE
ECONOMICS SECTION
INDUSTRIES SECTION
STATISTICAL SECTION
ECONOMICS RESEARCH
INDUSTRIES RESEARCH
CORPORATION RESEARCH
DOMESTIC POLITICS
TARIFFS
DOMESTIC FINANCIAL- FEDERAL- RESERVE, ETC.
STEEL INDUSTRY
COMMODITY EXPERTS
FOREIGN FINANCIAL
RAILROAD INDUSTRY
FOREIGN POLITICS

from any financial interest whatsoever, directly or indirectly, in the sale or purchase of securities.

A third condition is, of course, that the executives of such a management be men of integrity, ability and experience.

With those corner stones to build on, let us look at the organization of a successful, expert and unbiased investment management.

The chart is not intended as a complete portrayal of the entire organization by any means, particularly as regards the fact-finding activities which extend into every section of this country and many foreign countries. The relatively few fact-finding examples shown, will, however, serve to illustrate how facts are gathered; sifted through the various research departments, where they are commented upon and elaborated from kindred historical occurrences; and then passed on up to the executive departments and finally on to the Co-ordinating Executive Committee.

Consider, for instance, the "domestic politics" fact-finding agency. (And first let me say that the facts uncovered by such a department are frequently as much unlike the newspaper reports and propaganda you and I hear, as day is unlike night.) The domestic politics fact-finding agency learns from an indisputable source that the administration is contemplating inflation. This information is passed to the three research departments. "Economic research" immediately begins an intensive re-study of inflation throughout the entire period embracing the history of money. English, French, German and our own Civil War inflationary experiences are carefully considered. Within a reasonable period—perhaps several months—the Executive Economics Section has before it a study of inflation and its effects which would make my

feeble letter to you on the subject look like a few desultory memoranda.

In the meantime "Industries Research" is taking up its end of the work. A thorough investment organization has a specialized expert in charge of each major industry. The railroad division is headed by an authority on railroads, a man particularly expert in railroad financial problems. A mining specialist, expert in metallurgy and in mining finance, heads the metals and mining division. A man skilled in the operation and financing of electric light and power companies heads the public utility division. An so on, down through the major industries. Oftentimes the only advice of such an industry division, for a period of several years, is to stay out. In the situation we are considering, these industry divisions are considering the inflation problem. Its probable effect on a score and a half of industries is studied and plotted and graphed; and within a reasonable period the "Executive Industries Section" is able to draw some pretty concrete conclusions as to what is most likely to happen to the various industries as a result of inflation.

Meanwhile the statistical section has prepared its data regarding individual corporations and when the subject of inflation comes up before the Co-ordinating Executive Committee, some very sound conclusions can be drawn—and all of this, mind you, months, possibly years, before the general public becomes aware that inflation may be a menace to its purchasing power. Organizations of such scope spend several hundred thousand dollars per year in fact-finding and research; and employ a personnel often numbering hundreds of people.

While the Government is conducting a tremendous propaganda for the purchase of government bonds, and the pub-

lic, unskilled in investments, is bidding for these and for the "next best" municipal bonds; the able, farseeing investment manager may be quietly taking his clients out of these "inflation loss producers" and directing their investments into channels which will protect their purchasing power. Of course he does it too soon. He knows that he is probably too early, just as he knew in 1929 that he was too early in getting his clients out of common stocks. But he is too good an investment manager to take the risk. His first aim is to conserve capital; that is, if he is a good investment manager.

Agencies which merely attempt to supply the demand created by the misconceptions of unskilled investors, have no need for such an organization as this. Why should they spend hundreds of thousands of dollars per year to find out, among other things, (as did the best investment counsel organizations) that a great depression was imminent? Such a conclusion, if acted upon, could only signify that no sales of securities (in which there was a profit) should be made. The broker, true, could have made his profit just as well out of short sales, but the fact that no such advice emanated from brokerage offices during the long dismal down trend from 1929 to 1932, proves conclusively that they came to no such conclusion; or if they did it was not reflected in advice to customers.

"Investment Management" or "Investment Counsel" organizations of the scope of that described above, usually limit the size of the accounts which they will take for management to a minimum of $100,000—preferably more, but never less than that. I realize that you are not in the $100,000 class as yet, and in my next letter will tell you about getting this type of management for such capital as you may now have.

This type of "Investment Management" or "Investment Counsel" must not be confused with the investment "Services" with which the country abounds. I was amused the other day at a young fellow from New York who was calling on me in the interests of his house—a firm of investment bankers. I referred to my investment managers, whom he professed to know very well. "Oh yes," he said, "we subscribe to their service. We subscribe to all of those services. That gives us a great advantage over the individual who cannot possibly have use for more than one or two at the outside," etc. I pointed out that my investment managers had no "service," that the only way their counsel was given was to accounts under their direction. The young man was quite discomfited.

Before closing this letter I want to warn you once more about the claims to excellence of unknown "investment managers," unscrupulous "investment counsel," etc. Some of these parasites on an honorable profession have been known to recommend the purchase of a certain stock to one group of people, and its sale to another. Then whichever way it goes, they are right with half of their clients. The next time they do the same thing with that portion of their original group which profited the first time. This process is repeated a number of times with the final result that a few lucky people are convinced of the infallibility of the "advice" From these it is easy to get testimonial letters, with which a new group is intrigued. Be careful of testimonial letters. The best investment managers do not resort to this form of advertising. They don't have to. Their clientele comes largely from the very wealthy and is developed by word of mouth—the recommendation of friend to friend.

Within the past several years several of these extreme-

ly high grade, extremely successful investment counsel or investment management organizations have commenced to afford their management to the investor of average means (less than $100,000) through the medium of "Funds" over whose investment policies they have absolute control. No interference from the sales managers of such funds, is tolerated. The investment managers have built up their reputation for managing money. They have hundreds of millions of dollars under their direction. Their selfish interest is to perpetuate that good investment management reputation—not to make sales

I am rather partial to a fund of this kind, particularly at this time, because I do not see how the investor of average means, or the local investment dealer, can possibly have the facilities for selecting sound foreign securities (especially stocks) in the event that it becomes necessary to use them as an inflation hedge. And I am very positive that it is entirely impracticable for the individual investor (and otherwise profitless for the dealer) to attempt the purchase of half a dozen or more commodities, such as perhaps rubber, copper, silk, tin, wool tops or sugar, in the event that inflation demands the purchase of commodities. Such a fund as I have described, therefore, becomes a most logical medium for at least a portion of today's investor's capital. My next letter will tell you how to test such a fund.

Your affectionate father,

JOHN GORDON

LESSON NO. 19

Men high in the ranks of a given industry are usually poor investment advisers regarding that industry

An elaborate organization is necessary to achieve true investment success

Beware of testimonial letters They usually mark the impostor.

Letter No. 20

THE TEST

Chicago, October 20, 1934

Dear Robert:

In my last letter I told you that the best Investment Management or Investment Counsel organizations found it unnecessary to advertise extensively; that they never use testimonial letters; and that it is therefore difficult for one not acquainted with their immediate clientele to become apprised of the record which has attended the expert *and* unbiased efforts of successful Investment Management. I also told you that I would nevertheless equip you with an infallible test of their managerial ability.

But before proceeding with the test, I want to refer once more to Dwight C. Rose's book, "The Practical Application of Investment Management." Mr. Rose, through his long affiliation with the original firm of investment counsel, is able to report on the record of the first five accounts supervised by Investment Counsel. As a yardstick to measure these results, in relation to other sources of investment management, he uses the investment management records of the five largest United States fire insurance companies, whose investment management is generally recognized as being far superior to that of the average investor. The period used for comparison is January 1st, 1920 to January 1st, 1931. Suitable adjustments are made for legal restrictions applying to the fire insurance companies. Underwriting results were, of course, not included. Deducting the riskless rental value of money (estimated at 4.31% per annum for

the period) to ascertain the "net accomplishments attributable to managerial skill," the following conclusions are arrived at:

(1) Net results of the five investment counsel funds were 3 6 times as good as those of the five largest United States fire insurance companies.
(2) Net results of the most successful investment counsel fund were 2 4 times as good as those of the most successful fire insurance company.
(3) Net results of the least successful investment counsel fund were 3.3 times as good as those of the least successful fire insurance company.
(4) Net results of the least successful investment counsel fund were 1.2 times as good as those of the most successful fire insurance company!

Surely these results warrant the earnest attention of every investor who is seeking expert *and* unbiased investment advice.

While the records of individual Investment Counsel accounts are unavailable to the public, the success of a number of Investment Counsel managements is clearly portrayed in the records of their "Investment Counsel managed funds" now on the market. These funds are usually quoted in the daily papers along with a large number of investment trusts —fixed, restricted management, and general management. This allocation, for quotation purposes, of the "Investment Counsel managed funds" along with the investment trusts, is confusing. My feeling regarding Investment Trusts and Investment Counsel managed funds is just the same as chronicled in the first paragraph of my letter No. 18. I would just as soon get good investment management from the one as

from the other. The name again makes the management no more than clothes make the man. What I want you to understand is that you are to look for *management,* regardless of the name by which it is called and regardless of its association for quotation purposes. Neither deny the Investment Trust nor accept Investment Counsel Management because of their names.

But let us see how to distinguish the good management from the poor. "The Investment Trust Yardstick," which I mentioned in a former letter suggests a list of eighteen test questions for judging investment trusts. Many of these tests will help us.

Testing Investment Management

No 1 Test:—There can be no test of such prime importance as "results achieved." Theories, no matter how logical and appealing, mean nothing until tested in the crucible of actual experience The unsuccessful management may throw up a smoke screen to avoid discussing that most important question—the measurement of investment accomplishment: Current dividends. Size of fund. Names of directors Financial strength of sponsors. Management restrictions Listing Current portfolio. Small management fee. Trustee or custodian. Price of shares. Voting control. All of these and many more are sometimes brought to the fore to distract the prospective customer's attention from almost the one and only thing by which he can judge the investment management ability of those who are offering management for his capital.

The sponsors of many of the trusts which had poor management records during the depression have set up new trusts since, and are pointing with pride to their successful

records of accomplishment in a rising market. This is no test. Anyone can manage money fairly successfully in a rising market. *Of far greater importance to the inquiring investor is the record of previous trusts, sponsored by the same management, in operation during the depression.*

Some thoughtless investors are at first skeptical of this "Measure of Investment Accomplishment" test. They point to the poor "record" during the depression, of a high grade stock like American Telephone and Telegraph Co. These people do not stop to consider that American T. & T. was in the telephone business and could not get out. No matter how good their management was, the price of their stock had to go down with the general market because it was the wrong time to own *any* common stocks! It remains for "investment management"—as I have tried to show you time and time again in these letters—to determine when common stocks should be bought and when they should be avoided.

Any management which is restricted, or whose policy is "to hold a group of common stocks" cannot be called investment management. It sidesteps the most important function of investment management—the fitting of the proper types of investment to the current trend. With such restrictions or such a policy, *you* will have to decide when you should sell out your shares and reinvest in other types of securities. Real investment management, the kind you and I are looking for, should do that for us. If you buy "restricted management" or if you buy a trust whose "policy" is to "hold a group of common stocks," then don't blame that management later if you take losses because you failed to sell out on time. It will be your fault, not theirs.

The No. 1 Test of managerial ability then, is management

results. And this test must extend through a period of falling prices as well as one of rising prices. When investigating investment funds, you should demand the record not only of the fund under consideration, but of all previously offered funds under the direction of the same sponsors.

Other Less Important Tests:

In addition to the proof of investment management ability, the investor should check the fund he contemplates investing in for the following points:

(a) Be positive that the sponsors—the *sales* managers—have nothing whatsoever to do with the *investment* management of the fund. Not only must the sales managers have no active part in the investment management but the latter must not even be under the control of the sales managers. This condition is certain to be met if the investment management is under the direction of one of the large investment counsel organizations, the great majority of whose business comes from individual clients. You can be sure then that the prime motive of such investment managers will be to maintain their good reputation for investment management and that they cannot be influenced by sales expediency.

(b) The investment managers, as we have seen before, should be well paid; and their basis of compensation should be an annual percentage of the amount of capital under their direction.

(c) The investment management must, of course, be precluded from any financial interest in the purchase or sale of securities it buys or sells for the fund.

(d) The fund should have no warrants or options outstanding which will dilute the investor's interest.

(e) The fund must be free from restrictions which will hamper the investment managers.

(f) The shares of the fund must be redeemable at the option of the purchaser. This is very important as it constitutes a club over the investment managers. If the shares are redeemable and the management does something which you do not approve, you and all other investors can cash in your shares and leave the managers no fund to manage. But if the shares are not redeemable, the managers can be as inefficient as possible and the fund is still theirs to manage. The listing of an investment fund on an exchange, if it abrogates the privilege of redemption, is a distinct disadvantage to the investor.

(g) A satisfactory degree of marketability is achieved if a major portion of the securities comprising the fund are listed—or, if a commodity, traded on a recognized exchange.

(h) The management should disclose frequently (at least every three months) what constitutes the fund's investments.

(i) Whether the management should or should not be able to borrow money depends upon the investor's willingness or unwillingness to trade on margin.

(j) There should be a reasonable limit for investment in a single security or commodity, say not to exceed 10% of the entire fund.

(k) Salaries and expenses chargeable to the fund should be limited, preferably to a percentage of the amount of the fund. This is, of course, separate and distinct from the fee paid to the investment managers.

(l) The property of the fund should be under the control of a bank as trustee or custodian.

(m) Voting control should be vested in the shareholders.

(n) A statement of investment policy should be made by the investment managers and you should be sure that they operate on the "long trend" basis.

(o) You should look for the financial responsibility of the sponsors, but this is relatively unimportant as compared with investment management ability. If the fund disintegrates and has to be liquidated, all you will lose is the commission or "load" you have paid, to get in—usually 6% to 10%; but if the investment management is not good, you may lose 40%, 60% or 80%.

These considerations (a) to (o) are important and I do not believe I would miss considering any of them, but don't get sidetracked onto the minor points. Bear in mind that a good investment management record, through bad times as well as good, is of more importance than all of the rest put together.

There is one more point I want to make here which may have escaped you. It is a fine point, but a very important one, so follow me carefully. The salesman or dealer who sells you an investment fund, set up and operated as I have specified, *is not selling you an investment.* He is selling you the services of the investment managers of that fund. Today such a fund might comprise 30 common stocks. Next month it might be 15 stocks and four or five commodities; and six months from now it might be a group of bonds, or cash. This is not the same as selling you a single stock or a bond, nor the same as selling you a group of stocks in the ordinary run of investment trusts which are "fixed," or "restricted," or "limited" or whose "policy is to invest in a group of stocks." The latter are selling you investments and the former is selling

you management. The seller of any investment should always be viewed with a "fundamental suspicion," says Rose; a suspicion that he or his principal want to exchange their security for your money. But the seller of a "management" such as I have described has no investment to sell. The *investment* management does not make a dime out of that sale to you of their management facilities. Nor does it make a penny out of any sale or purchase for the fund. This is a fine point, as I said above, but it is not hair splitting. The investment managers are paid only for managing your money. The dealer or salesman who sells you investment counsel management is, for a fee, putting you in touch with a high grade consulting physician, instead of selling you a patent medicine. The element of having something to sell is entirely eliminated. The physician will regulate your dosage and change your prescription from time to time as changing conditions warrant.

If you have "made your decision" (as I did many years ago) that you are going to be too busy in your own business to devote the time and money necessary to become an investment expert, the above rules should enable you to select an investment management which has proved itself to be expert *and* unbiased.

Your affectionate father,

John Gordon

LESSON NO. 20

For your investment advisers, be satisfied with none except those proved by test to be expert *and* unbiased investment managers.

Letter No. 21
CONCLUSION

Chicago, November 1, 1934

Dear Robert:

In my first letter to you I said:

"So much you and I read on investments, it seems to me, tends to perpetuate our ignorance of finance, our unfounded hopes and unwarranted fears, our foolish prejudices and misconceptions. Most newspaper articles and almost all of the financial advertising we get, appear to me to be aiming at supplying the demand of untutored investors for something they do not need, and should not have, instead of teaching them what they should be looking for. In this and subsequent letters I am going to try to unmask those hopes, fears, prejudices and misconceptions; and leave you a clear perspective of the real problems which confront you as an investor—as a manager of money."

I hope I have succeeded.

You have not been highly successful in conducting your own investment management and you have been sorely disappointed in the results achieved by several other sources of investment advice. But don't be discouraged, Robert. Like so many others you have misconstrued the functions of some investment advisers and misunderstood the motives and abilities of others. You must have investment advice. You can't even leave your money in a safe-deposit box under present conditions and be sure that it—or its value—won't be taken away from you. You must devote yourself chiefly to finding a source, or several sources of expert and unbiased

investment advice. Never mind its cost. There is nothing cheaper than good, high-priced investment management. And then remember that your expert and unbiased managers will frequently take the unconventional course. The general public will be buying stocks when they are in cash equivalents. The general public will be buying bonds when they are in common stocks and commodities. The general public will be buying "a conventional list of high grade dividend paying stocks" when they are buying those of non-dividend-paying industries, which are coming, rather than going. The general public will be clamboring for income while they will ignore it. The general public will be hanging on while they are taking losses; or taking profits while they are hanging on. In short, as my investment managers recently said to me: "We are 'wrong' about four-fifths of the time, but somehow our clients seem to lose less money in bad times and make more in good times than those who so frequently have us wrong."

Select your investment advisers carefully. While you have less than the required minimum, use for at least a part of your capital, the "funds" managed by the big investment management or investment counsel organizations which have proved their ability by their record through bad times as well as good. Many wealthy investors even prefer this method to that of receiving advice as to what to do, because it removes the temptation to succumb to their own whims which may not be in accord with their investment managers' advice. Don't put all of your capital in any one fund. Don't even put it all in several such funds. Select one or two or three with good records and properly set up as outlined in my letter No. 20. You can derive a double benefit from such investments First, you will have good management for that

portion of your capital thus invested. Second, you as well as your local dealer or salesman, can learn from the quarterly or semi-annual reports what types of securities and what industries these able, unbiased managers consider advisable. Don't be a hog in this suggestion and try to manage $50,000 worth of capital with the "free information" you get with a $1,000 purchase. Sometimes things happen quickly and you may find that you are several months behind.

Select your managements carefully, on their past record of achievement. Then rely upon them. Realize that they cannot be perfect. Understand that investment management is not an exact science. Appreciate that they are not even attempting to follow short swing market fluctuation. Grasp the fact that they are doing their expert and unbiased best, first of all, to conserve your capital. Construe either temporary minor losses, or failure to garner every possible dollar of profit, as insurance premiums you are paying against the possibility of greater losses Even a perfect "inflation hedge" investment program, for instance, is almost certain to pass through temporary periods when the conventional investment list will outdo it, in short swing results.

Says my investment manager again:

"Investment success requires an infinite degree of faith and belief in the action which is being taken The courage and long difficult patience which are so necessary to the successful backing of investment judgment are impossible unless supported by an understanding faith in what is being done."

And now, Robert, a final word to sum up my whole series of letters And please THINK while you are reading this:

Investment Counsel

You cannot rely upon investment counsel just because it calls itself investment counsel. Even though it be unbiased,

it cannot serve you well unless it is also expert. Only its record of management will be a sure test.

Advice, Both Biased And Inexpert

We have seen that, under favorable circumstances, even the advice of a source both biased and inexpert, may be temporarily good, perhaps for several months or even longer

Advice, Unbiased But Not Expert

We have seen, again under favorable circumstances, that unbiased advice, though not expert, may be temporarily good; and in the long run it will be better than advice which is both inexpert and biased.

Advice, Expert But Biased

We have seen that expert advice, though biased as far as most of its clientele is concerned, if truly expert, may almost always be good to certain favored clients, whose relations with the source are such that the bias is overcome.

Expert And Unbiased Advice

But we have never found a situation, and no one ever will, whence consistently good investment advice, year in and year out, can come, unless that source is both *expert and unbiased.*

I have given you the means of testing for expertness and for bias I leave you now to plot your own course. I have told you all I know about investment management Counsel with your local dealer or salesman, if he proves worthy after testing him as suggested in Letter No 17.

Great names, big talk, marble and mahogany, and poor excuses have failed us. It is time to judge ability by results

Your affectionate father,

John Gordon

The End

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